Background For

FINANCIAL MARKETS DEVELOPMENT

IN UKRAINE

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Financial Markets International, Inc. (FMI) has been assisting financial markets development in Ukraine since 1996. FMI has assisted the Securities and Stock Market State Commission with respect to legal and regulatory issues, corporate governance, financial disclosure, and collective investment institutions.

The findings, interpretations and views expressed here are those of FMI, specifically Charles M. Seeger and Hugh C. Patton. Comments are welcome.

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Preface

This Paper presents a broad array of financial markets initiatives for consideration by Ukrainian State officials who are trying to revitalize the economy. An underlying premise is that enterprises in Ukraine are in desperate need of capital, know-how, and corporate restructuring, and that under-developed financial markets are one of the primary causes. By examining the many facets of the existing financial markets and proposing improvements, this Paper suggests initiatives to develop the financial markets in order to expand the economy and create jobs.

Ukraine's economic statistics are startling. Eleven years of declining gross domestic product (GDP). A shadow economy that exceeds 50 percent of GDP. More than Hr 15 billion ($3 billion) in foreign debts due in 2000, while the National Bank of Ukraine (NBU) has just over a third of that amount in hard-currency reserves. An entire banking sector the size of one large Central European bank. A securities market in which perhaps 80 percent of trades are settled outside of Ukraine.

And yet reforms are occurring. Developing this Paper was a challenge because the text constantly had to be amended as a result of some new decree, regulation or law. Many of the changes are quite positive. Ukraine has privatized more than 80 percent of its medium and large enterprises, and recently taken steps to speed up privatization of its "strategic" enterprises. It has significantly reduced the number of annual inspections undergone by the average small and medium-size business; initiated a major accounting reform effort; recently passed a modern bankruptcy law; eliminated "off-budget funding" for almost all agencies starting in 2000; liquidated the National Agency for the Management of State Corporate Rights (NAMSCR); and reduced the number of Government agencies from 89 to 46.

Why such economic stagnation if reforms are underway? It seems that reforms to date have resulted in a malady of "bureaucratic capitalism" – where the Government continues to exert formal and informal influence over enterprises, and control production and distribution decisions in the economy – rather than facilitating a vibrant free market. As a result, living standards continue to decline. The only conclusion is that the incremental method is not working. What is needed is dramatic reform, rather than small measures and compromises. *Systemic* change is necessary in the way Government is organized and operates, businesses develop and grow, and citizens participate in and shape society.

While this Paper presents scores of policy initiatives to spark such systemic change, importantly Ukraine already has at least one valuable example of economic growth caused by greater freedom: Ukraine's food sector. This sector has attracted more foreign investment than any other, largely due to limited Government interference. Foreign investment has brought new production equipment to create quality, attractively-packaged products that are gradually replacing imported foods. And local competition has necessitated advertising campaigns, bringing money into yet another sector. The Government's hands-off approach is in large part the reason that the food industry has prospered. This sector offers a small picture of what the entire economy could look like if the Government reduced its role.

Ukraine is currently stagnated halfway between a command and a free economy. Ukrainian citizens made it clear in the November 1999 elections that they have no desire to return to a command economy. The only choice is to complete the transition to a free one.

We hope that this Paper serves to stimulate discussion among Ukrainian policymakers, resulting in bold action to improve the financial markets and the economy in Ukraine.

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"We could trot out the usual recipes for success – rapid privatization, cuts in subsidies, reform of the Government, and so on. But these have all been proffered before in the pages of this and other Ukrainian newspapers. Many, many times before. It's not that these cures for Ukraine's ills have failed, it's that they've never been even tried. This is the real essence of Ukraine's current plight. Since independence, no one in power has been serious about reform. So the issue now is not about policy . . . . We all know what has to be done to pull Ukraine out of its economic nose-dive. The question is, who's going to grab the throttle?"

- Editorial in the *Kyiv Post*, November 25, 1999, urging appointment of a strong Prime Minister who will lead the reform effort.

This Paper provides a broad overview of the needed reform agenda for financial markets development along with constructive suggestions to get it done. But reform needs a champion – or many champions. Ukraine can be an important and prosperous nation, but to get there, it must finally initiate a serious and sustained reform effort.

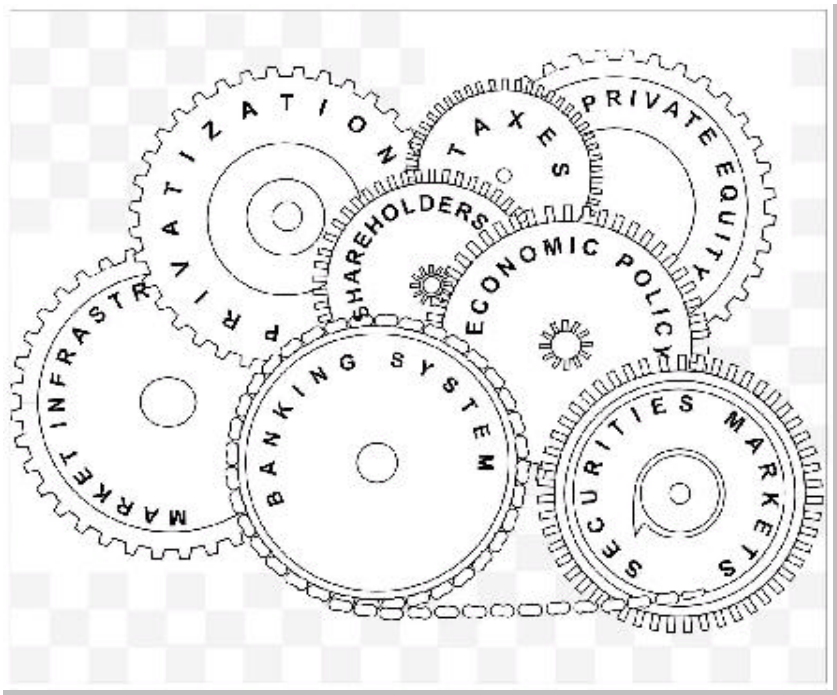


Table of Contents

Organization of the Paper

This Paper is divided into eleven chapters. For the reader's convenience, the Paper also includes three different types of "summaries." First, at the beginning of the Paper is a section entitled *Highlights and Key Recommendations* that summarizes in a few pages the Paper's most important ideas and suggestions. Second, each chapter concludes with a series of *Action Points* that summarize the specific initiatives proposed in the chapter. These Action Points are listed in the same order as the proposals appear in the text, and thus can be used as an index to help find the discussion of a given topic. Third, at the end of the Paper is an *Executive Summary* that is essentially a distilled version of the entire paper.

Table of Graphs, Figures and Boxes

Highlights and Key Recommendations

Financial markets function like the "brain" of an economy, distributing capital to those enterprises likely to be profitable and grow, and facilitating restructuring and modernization. Unfortunately, Ukraine's financial markets are failing to adequately perform these functions, and this failure is contributing to the country's continuing economic decline. Thus, we urge Ukrainian policymakers to develop and implement a comprehensive plan to rapidly develop the financial markets, and hope that this Paper will facilitate the process.

As a prerequisite to effective financial markets development, several broader problems must be addressed. Perhaps most importantly, the bureaucracy's control over the economy must be reduced. The economy should be deregulated and the administrative process streamlined and made more transparent. Further, corruption must be reduced at all levels. From State officials to judges to enterprise managers and controlling shareholders, corruption undermines confidence in the financial markets. Finally, the shadow economy must be reduced. Financial markets cannot function properly when economic actors avoid financial market institutions in order to escape detection.

Policymakers should keep certain principles in mind when developing a strategy for financial markets development. First, the aim of almost all decisions related to financial markets development should be to increase *transparency* in the market and/or the *confidence* of participants in financial markets institutions. Second, financial markets involve complex and interrelated systems. Government fiscal, monetary, tax and privatization policies will have significant effects on financial markets development. And giving preference to certain sectors will often have negative consequences for other sectors, in the long run doing harm to the system as a whole. Third, the pathway to financial markets development starts with sound legal foundations: a modern civil code and financial markets laws, shareholders' and creditors' rights, accounting standards, required disclosure of information, and judicial enforcement of contracts and protection of property rights. Fourth, administrative agencies should strive to more effectively focus their activities. Currently, administrative agencies with law enforcement responsibilities too often focus on purely technical violations rather than serious violations that do real harm to the market. Similarly, tax collection efforts are not prioritized in an efficient manner. And the costs of regulations issued by ministries and agencies too often outweigh the benefits.

Privatization is the first step in financial markets development. Importantly, it is only where privatization is associated with good corporate governance and restructuring that there is a positive impact on growth. In a country such as Ukraine, with a weak legal system and, in particular, poor shareholder protections, the initial share allocation in privatization should be highly concentrated, with a core strategic investor receiving at least a majority share. A dispersed shareholding pattern would require legal protections and enforcement mechanisms that take decades to develop. Similarly, incremental privatization is not the optimal approach because it requires a great deal of time to assemble controlling blocks of shares and the value of enterprises will deteriorate in the meantime. Privatization will be most effective if the majority investor is not current management, but rather an outside strategic investor with experience in the sector, a good management record, a strong reputation to maintain, and its own good corporate governance practices. Care must be taken in screening bidders, however, because a dishonest bidder may offer more money than an honest bidder. The dishonest bidder has an advantage in that he intends to evade taxes, "cheat" while fulfilling investment obligations, not pay workers, and engage in asset stripping and profit skimming.

Large scale privatization without a comprehensive law on joint stock companies is dangerous. Particularly important are provisions to protect minority investors from abuses by controlling shareholders. Consideration should be given to breaking enterprises into smaller units before privatization, perhaps through the procedures of the new bankruptcy law.

The banking system and securities markets make up the core of the financial markets. Currently in Ukraine, however, neither is contributing significantly to the economy. Ukraine has one of the smallest banking systems in the world, relative to its gross domestic product (GDP). Moreover, Ukrainian banks do not have adequate risk monitoring systems in place or any way to gauge the risks associated with lending to enterprises, and therefore banks generally avoid extending loans. New approaches are needed to attract additional equity capital and new sources of profit into the banking sector, reduce real interest rates to more sustainable levels, and stimulate commercial lending. An important step would be to finalize and pass the revised law "On Banks and Banking Activity" in order to improve the legislative and regulatory framework. Policymakers should encourage the merger of smaller banks with larger banks, and close or reorganize banks that do not meet capital and other requirements.

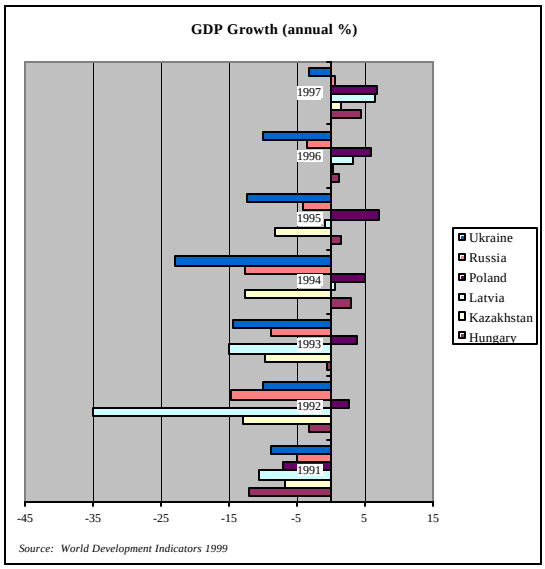
Securities markets in Ukraine are also underdeveloped, with most securities trades agreed upon and settled away from the organized markets and often outside of the country. Policymakers should work to attract trading and settlement onshore and into the organized market. Further, there are too many market intermediaries; the Securities and Stock Market State Commission (SSMSC) should raise standards, encourage consolidation, and revoke licenses from non-complying intermediaries. Infrastructure risk remains high. A single, reliable participant-governed clearance and settlement depository is crucial for market development, along with elimination of the uncertainty caused by multiple depositories and potential depositories.

Collective investment institutions such as investment funds and private pension funds can play a major role in enhancing economic growth and bolstering retirement living standards. In transition economies, however, development of collective investment institutions is often jeopardized by various factors such as: i) fear that corruption will lead to stolen assets; ii) the likelihood that policymakers will mandate *domestic* bonds and shares as the predominate permissible asset classes for investment, thus ensuring risky investment; and iii) fear that inexperienced custodians, investment advisers and management companies, coupled with inadequate legal safeguards and regulatory oversight, will threaten routine operations. Policymakers should focus on developing the legal, regulatory and institutional framework to overcome these obstacles and facilitate the development of a vibrant collective investment industry in Ukraine.

Ukraine can develop a competitive financial sector capable of mobilizing investment resources and making them available to productive enterprises, but it will require a concerted effort. The destructive dynamic, in which the failure of reforms leads to less investment, looting of enterprises, and more failure, must be reversed. This will require bold action to implement a constructive dynamic where reforms lead to investment and further reforms. Real reform will be reinforcing.

1. Rationale and Framework for Reform

Background. Since independence, Ukrainian policymakers have set a course toward a market economy. Unfortunately, over half a century of central planning has left serious constraints on development of a new market-oriented system in Ukraine. In part because of this, in part because reforms have been halting and incremental, the reforms implemented so far have not produced a healthy economy. Instead, Ukraine has endured eleven years of declining gross domestic product (GDP). Today the situation has reached a crisis point. The Government is in danger of defaulting on its short term debt obligations due in the first quarter of 2000, which would further tarnish Ukraine's reputation internationally and significantly set-back the promised reform effort.



The fact that Ukraine is viewed by the international investment community as unpredictable in its commitment to the structural reforms needed to facilitate economic development complicates the situation. This view has been created in part by well-publicized incidents that have been reported to the world's investment community. By way of example:

- Motorola abandoned plans for a major investment in Ukraine to build a cellular phone network. Motorola's asserted reason was the "ever-changing terms and conditions of the license" it had been awarded through a Government tender.

- Dniproshyna stunned foreign investors when its managers dramatically diluted shareholder value by issuing new shares to themselves and a selected investor at a fraction of their trading (market) value.

- Procter and Gamble (P&G) had one-half of its product certifications canceled by the Ukraine State Standards Committee. This resulted in suspended sales and advertising, and P&G asserting that Ukraine regulations are "ill-defined, constantly changing, and make the Ukraine system impossible to operate under."

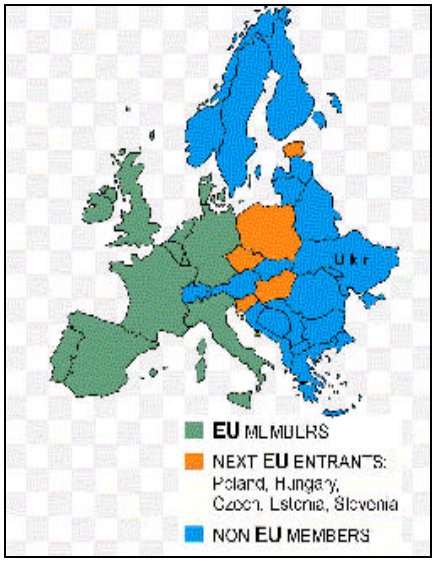
- The rules on real-estate purchase and leases by foreign companies were abruptly reversed by the Ukraine HDIP (the office that deals with foreign non-diplomatic representatives). The British and American Chambers of Commerce protested this action by informing President Kuchma that the HDIP action was directly in conflict with the Cabinet of Ministers' (COM) regulations and previous Ukrainian practices.

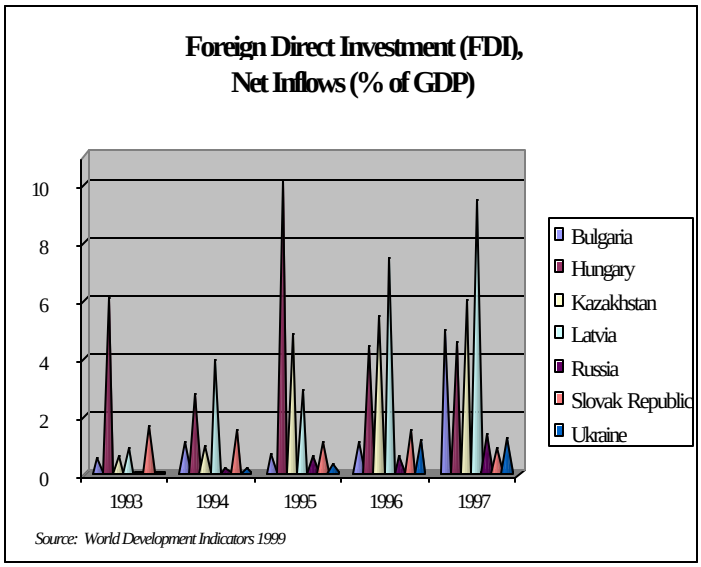
- The Verkhovna Rada repeatedly enacts and cancels tax privileges for foreign investors.

- The State Property Fund (SPF) canceled its first international privatization tender for energy distributor Donbasenergo because the Verkhovna Rada overruled an earlier Presidential decree on tender procedures. CS First Boston, Britain's

Schroeders, and Austria's Creditanstalt all complained that this showed Ukraine as an unreliable country for doing business.

These vignettes, and others like them, illustrate that Ukraine's past actions have given investors an impression of Ukraine as an unpredictable, and thus hostile, environment for capital inflows. Uncertainty and susceptibility to corruption continue to deter financial markets development. The result is that Ukraine has suffered in attracting capital inflows and in energizing domestic savings, particularly in comparison to its smaller neighbors such as Poland, Hungary and Bulgaria. While Hungary in 1998 attracted per capita foreign investment of $1,750 and Bulgaria $140, Ukraine attracted only $40 per capita.[1]





Economic Revitalization Through Financial Markets Development. Financial markets are critical to any effort to revitalize the Ukrainian economy.[2] Growth leads to

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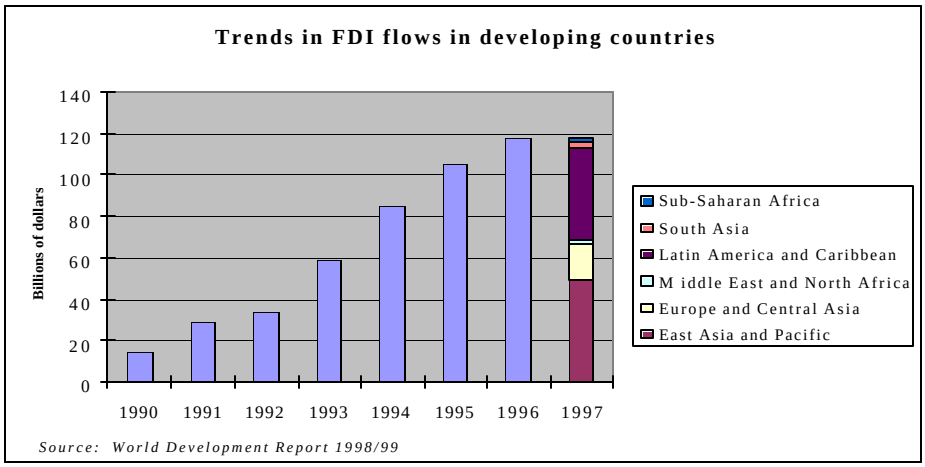
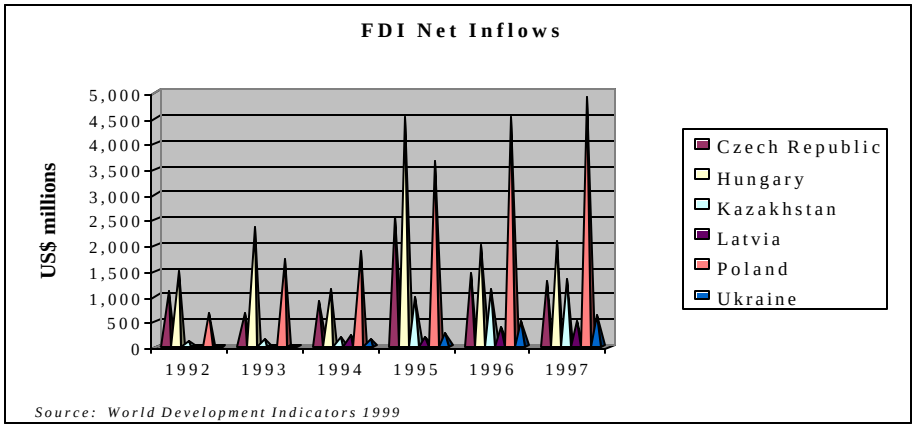
[1] Ukraine received a meager Hr 2.253 billion ($450.5 million) in foreign investment from January to September 1999, or Hr 1.04 billion ($208 million) less than over the same period in 1998. Foreign investment in Ukraine since independence has totaled Hr 15.5 billion ($3.1 billion), several times less than Poland and Hungary. (Interfax; *Wall Street Journal Europe*, November 5-6, 1999, p. 2.)

[2] Ukraine's economy today is characterized by: i) Government policies that focus on control instead of economic liberalization; ii) burdensome and conflicting laws and regulations that hinder development; iii) ill-defined property rights and inadequate contract enforcement; iv) high taxes; v) a large shadow economy, between 50-70 percent of GDP; vi) corruption; vii) a weakening currency; viii) an absence of hard Government budget constraints; ix) a debt crisis involving short-term Government debt obligations due in 2000-2001; x) large pension arrears; xi) large State-owned enterprises that are inefficient and insolvent but supported by tax breaks and other privileges; xii) dramatically increased energy costs; xiii) diminished intra-CIS trade and insufficient replacement markets; xiv) a scarcity of domestic and foreign capital necessary to fuel privatization; xv) an inability to absorb large numbers of displaced workers; xvi) poor corporate governance and limited post-privatization restructuring; xvii) a tiny banking sector that is not making loans to productive enterprises; xviii) underdeveloped securities markets; xix) an absence of transparency or confidence in the financial markets; and xx) declining standards of living.

financial markets development, but financial markets development also leads to growth. Studies have shown that countries with developed banking sectors and securities markets experience faster development, other factors held constant.[3] Properly functioning financial markets will help to solve the problems that Ukraine has inherited from the past, because they facilitate the process of raising capital and distributing it to those enterprises that are likely to be profitable and grow. In this sense, financial markets are like the "brain" of the economy. Properly functioning financial markets will also facilitate restructuring of enterprises as new strategic investors assist enterprises to modernize their operations. Finally, financial markets will protect the financial security of individuals by providing a place for savings – particularly important since the public lost their savings during the hyper-inflation of the early 1990s.

> *If everything's under control, you're going too slow.*
>
> Mario Andretti





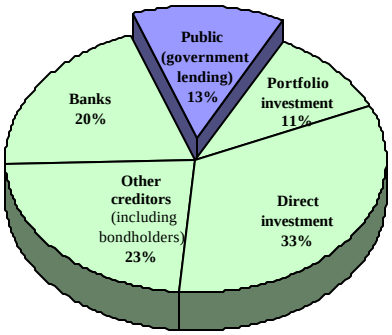
Productive enterprises are the basic building blocks of the economy, and the focus of any financial markets strategic plan must be on creating an environment that will help enterprises attract capital. Significant investment in plants and equipment is needed for economic recovery in Ukraine. The production infrastructure inherited from the Soviet era was already in need of replacement by the mid-1980s, when *perestroika* led to significant asset stripping. Further, much of the inherited

[3] World Bank, "World Development Report, Knowledge for Development," p. 91 (Oxford University Press 1998/99).

infrastructure was energy-intensive as a result of low energy prices during the Soviet regime, and was designed to produce Soviet-style goods that are not competitive today.

Functional financial markets will mobilize capital for investment in enterprises to replace outdated production infrastructure. Capital can be mobilized by: 1) attracting foreign direct investment into Ukrainian enterprises in the process of privatization, and through the actions of already privatized businesses; 2) expanding commercial lending to enterprises by strengthening the banking sector; 3) creating capital pools through new collective investment mechanisms for domestic savings; and 4) strengthening the regulatory and institutional framework across State bodies and the private sector to facilitate overall financial markets development. Domestic and foreign capital are both needed. Foreign direct investment is particularly important because such investors often contribute modern production techniques and know-how in addition to capital. But portfolio investment and debt financing are also important to the complete system – portfolio investment adds liquidity to the market while debt financing contributes capital without companies giving up control.

Net capital flows to 28 major emerging market economies*, for the years 1992 to 1998



Private 87%

* Algeria, Argentina, Brazil, Bulgaria, Chile, China, Colombia, Czech Republic, Ecuador, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Romania, Russia, Slovakia, South Africa, South Korea, Thailand, Tunisia, Uruguay, Venezuela

Source: *International Herald Tribune* , Monday, April 26, 1999, from the Institute of International Finance.

Linkages in the Financial Markets. What are financial markets and how can they be improved? In the broadest sense, financial markets are systems for allocating private financial resources in an economy. In a properly functioning financial market, financial resources are available and can be obtained by the enterprises that can best use them in pursuit of profit. The securities markets and the banking system make up the core of the financial markets,[4] but it is useful to also think of financial markets in broader terms, because properly functioning financial markets require *linked* activities between players in many parts of the private sector and the Government. Thus, when deciding how to improve financial markets, attention must be focused not only on banking and securities, but also on the broader systems and linkages that will have an impact on how the financial markets function. This requires a high level of coordination between policymakers in different areas.

Financial markets depend on good Government. Politics and economics are intimately intertwined – the court system, monetary and fiscal policy, actions of local and central authorities, the tax system, and State banks all have a significant effect on financial markets. There must be a legal and regulatory framework that provides stability and *confidence,* and that fosters the development of the private sector. On the private side, and working within this framework, there must be commercial lending, strategic and portfolio investors, clearing and settlement systems, depositories,

[4] The financial markets also include other non-bank financial institutions, such as insurance companies, leasing companies, credit unions, and factoring companies. See Box 3.1 in Chapter Three.

custodians, securities traders, and capital pools created by pension funds, investment funds and insurance companies.

It is the *system* of inter-linkages between and among Government and private institutions that must be fostered to develop effective financial markets. For example, tax policies must be fair and appropriately administered so that tax avoidance (and reluctance to use banks and other financial markets institutions) is not a dominant activity, so that people and enterprises pay their fair share based upon an appropriate measure of profit, and so that disclosure of information to the market is not distorted. Repatriation of capital must be freely allowed so that foreign investors are encouraged to participate in the market.[5] And fiscal and monetary policies must be sound to avoid, among other things: i) hyper-inflation; ii) rampant currency devaluations; iii) the threat of default on Government debt obligations; iv) demonetization of the economy and increased reliance on cash substitutes such as barter and negotiable instruments (veksels); and v) liquidity problems caused by the "crowding out" of enterprises' access to capital as a result of excessive Government borrowing.[6]

Securities markets development is *interlinked* with development and liberalization in other financial areas. For example, liquid securities markets require and attract foreign portfolio investors that can sell securities rapidly in large volume and repatriate capital – but this puts pressure on foreign exchange reserves. A floating exchange rate will mitigate the effects of such outflows, but can make repayment of hard currency obligations and importation of production inputs and finished goods more difficult.

There is also an important linkage between securities markets and government control over the money supply (the quantity of money in circulation). On the one hand, liquid securities markets provide a means for the exercise of monetary policy through issue and repurchase of treasury obligations. On the other hand, active securities markets alter the pattern of demand for money, and a booming stock market can create a liquidity and wealth "overhang" that is potentially inflationary. In addition, private debt securities markets can lessen the government's control over the money supply if companies can issue bonds and negotiable instruments (veksels) that have many of the characteristics of money. Tightening the money supply is an important tool by which governments control inflation. The government could respond by raising interest rates in order to make corporate debt instruments less attractive and thus reduce their supply, but such increased interest rates could divert savings from productive investment to passive interest earning. These are not arguments against development of active securities markets. The examples are only meant to show that financial sector reforms are interconnected, and that achieving

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[5] In light of the Asian financial crisis, some experts are talking about increased currency controls to stem rapid inflows and outflows of investment. We do not recommend short term capital controls for Ukraine, however, because Ukraine should be taking only actions to make itself more attractive for investment.

[6] An important inter-linkage involves efforts to support enterprises through tax privileges, cheap energy and other benefits. When policymakers take actions to support loss-making enterprises, these actions put stresses on other parts of the system, reducing budgetary funds available for investment in needed infrastructure, and increasing the tax burden on a narrow group of efficient, profitable enterprises that operate in the official economy. This increased tax burden further expands the shadow economy, which further increases the tax burden in the official economy – a reinforcing cycle. The expanded shadow economy, in turn, inhibits financial markets development, which prevents promising enterprises from receiving the capital they need to modernize and expand.

macroeconomic stability – a balanced budget and a reasonably low level of inflation – should generally precede economic liberalization in other areas.

Another important inter-linkage is that between accounting reform and financial markets development. Banking and securities markets require transparency, with accurate disclosure of all material information, so that decisions on allocation of financial resources are economically appropriate, so that financing is directed to viable enterprises and not wasted on failing ones, and so that managers and controlling shareholders cannot hide self-interested transactions. Further, adequate rules regarding secured lending and bankruptcy are important so that banks are encouraged to make loans to enterprises, and so that insolvent enterprises are reorganized (or liquidated). Secured lending and bankruptcy procedures, in turn, require enforceable contracts, which require laws that honor property and contract rights, and courts that have the power and integrity to enforce the law. And finally, financial markets require regulators that are focused on eliminating improprieties, without over-regulating or imposing unreasonable burdens, so that market participants can operate effectively. These linkages between government policy and the actions of private, profit-seeking entities are fundamental to financial markets development.[7]

Confident Expectations. Development and growth of financial markets requires an environment of *confident expectations.* Actors in financial markets must confidently expect that contracts will be honored and enforced; that loans will be repaid; that the Hrivna will hold its value; that the interests of creditors, shareholders, and managers will be protected; that financial information will be reliable; and that tax policy will be fair and consistent. Without such confidence, foreign investors will continue to by-pass Ukraine and domestic capital will continue to flow offshore. A culture of *confident expectations* has to be jump-started in Ukraine, yet we must remember it is a culture that evolved over many decades in the developed market economies.[8]

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[7] Increased linkages are also important between Ukrainian financial market institutions and international, regional, and bilateral institutions, so that Ukraine can rapidly integrate into the global market.

[8] Ukrainians today are distrustful of all financial market institutions, although this was not so immediately after independence. The public does not use banks or invest in the financial markets today because a series of problems and scandals since independence involving almost every financial market institution has completely destroyed people's trust of leaving their money anywhere other than under the mattress: hyper-inflation in the early 90s destroyed the value of money not in hard currency; "insurance contracts" promising high profits were in fact pyramid schemes that inevitably collapsed; trust companies took in money and then disappeared; investment companies and funds failed to deliver on the promised profits to persons that invested their privatization certificates; bank failures resulted in the loss of depositors' funds; and, most recently, payments were significantly delayed on treasury bills (a "voluntary" restructuring) and the real returns destroyed by a significant currency devaluation.

The other major reason that the public does not use banks or other financial market institutions is fear of tax consequences. The shadow economy is huge in Ukraine and many citizens have income that they do not declare to the State Tax Administration (STA). Anonymous (numbered) bank accounts were recently disallowed, and people fear that the STA will have access to information about the size of their bank account. Similarly, they fear that money invested with other financial market institutions may be disclosed to the STA.

When we speak of financial markets, we are speaking about something akin to an environmental ecosystem. Each participant fills its own niche, depending upon, and being depended upon by, other members of the system. If the market is to be healthy and expanding, the environment in which it operates must be fertile – i.e., the legal, regulatory and operational infrastructure must be conducive to growing the market.

Economic Functions in the Financial Market. A brief focus on the necessary economic functions performed by financial markets may facilitate consensual thinking on specific actions needed to enhance the financial markets and create this environment of *confident expectations*. Key functions of properly structured financial markets include the following:

1) A capital allocation function that evaluates the allocation of commercial loans, and financing through debt securities (bonds), based on past repayment history and the potential for repayment in the future; and the allocation of financing through equity securities (shares) based on past performance and the potential for future growth;

2) A *performance monitoring function* that ensures that money lent or invested is used in the way promised and includes efforts to minimize default, with respect to debt financing, and to ensure that profits inure to shareholders, with respect to equity financing;

3) A *corporate governance function* that facilitates accumulation of shares by large investors that monitor management and insist on corporate restructuring, and that encourages managers to perform in order to keep share prices high;

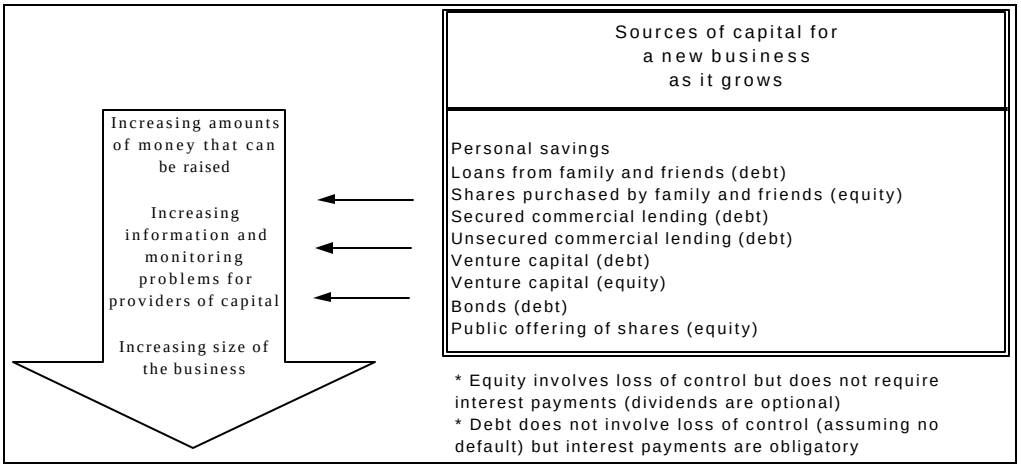
4) A *capital agglomeration function* that accumulates pools of funds available for investment or lending, recognizing that many projects require more capital than any one saver or group of savers can provide;

5) A *savings function* that provides citizens with a way to save for retirement that at least keeps up with inflation;

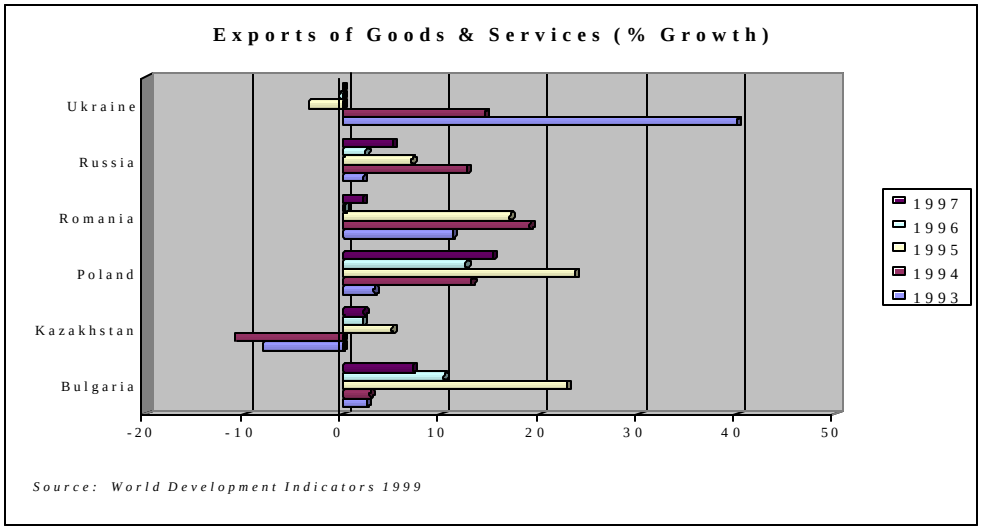
6) A *transparency function* that provides reliable information about financial actors, and facilitates efficient channeling of resources by ensuring that information is available about competing options;

7) A *payments transfer function* that records transactions and accomplishes the smooth processing of money movements, credits, and ownership transfers; and

8) An *exit function* that encourages investment by ensuring an easy exit from an investment in the future.



Legal and Regulatory Climate in Ukraine. Not all of these functions are being achieved in Ukraine today. One reason is that financial markets institutions with experience in achieving these functions simply did not exist in Ukraine's former statist economy. This absence placed great initial burdens on State officials who had to quickly develop laws, regulations and regulatory procedures to try to achieve these financial markets functions. The challenge now is to reassess this initial work and modify it as necessary, expanding in some places and reducing it in others. The goal should be to design all the necessary laws, regulations, and regulatory procedures to *facilitate* economic activity, and to not attempt to regulate what economic activity can occur, nor attempt to determine in advance which economic actors will succeed.



The Visible Hand. If financial markets development is to be successful, it will require that the "Gosplan mentality," where the State determines what actions will be implemented and then encourages their implementation, be replaced with a "private sector *enabling* mentality," where the State puts in place fair and consistent rules and the private sector itself determines what actions will be implemented.[9] In particular,

[9] Regulations issued by Government agencies, for example, should generally require a result rather than specify exactly "how to do it." If the regulator specifies "how to do it," then the opportunity for innovation and value-adding competition between regulated entities is reduced. In addition, the

Ukraine's economy is over-regulated, over-licensed and over-inspected.

John Oldling-Smee, head of the IMF mission to Ukraine, December 1999

the Government must give up its intrusive role in production and distribution decisions within the economy – the Government still routinely orders enterprises to supply certain customers before others, or raises export tariffs to adjust domestic supply to levels officials think appropriate. Government agencies must be restructured as promotion and assistance institutions rather than replicas of the planning committees of the past. The control retained by the branch ministries and other Government agencies, combined with complex and outdated regulations, is a breeding ground for corrupt practices and bureaucratic inefficiencies.[10] Enterprise managers should be focusing on investing and producing, not complying with complex regulations or competing for privileges and favors from the Government.[11]

This shift in mentality will require a change on the part of both State officials (to stop thinking of themselves as the architects of economic activity) and private sector actors (to show more initiative and shoulder more responsibility). In addition, ministries and agencies must stop defending their own and associated interests, and instead focus on the interests of the overall economy. What exists in Ukraine currently is a kind of "bureaucratic capitalism" rather than a true market economy. The focus of officials must shift to promoting a good business climate, which in turn will lead to growth and increased living standards.

Conclusion. An array of initiatives are suggested in this Paper for consideration by Ukrainian policymakers as they develop and implement a financial markets development strategy. The initiatives are broad and deliberately involve many State bodies, because of the necessary links in activities.[12] The suggestions are all State initiatives, but they are designed to elicit further private sector action. Some of the recommendations in the Paper are already underway and are included to paint a complete picture and/or to urge rapid completion; other recommendations are entirely new. This Paper does not pretend to present all possible initiatives that

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benefit to the public (or "to the market") of each norm of every regulation should outweigh its cost to the regulated entity. Each regulation should be published for public comment before it is finalized and passed. Finally, regulators should consider using pilot initiatives to test and refine programs, policies and operating procedures before adopting detailed regulations or implementing broad scale-initiatives.

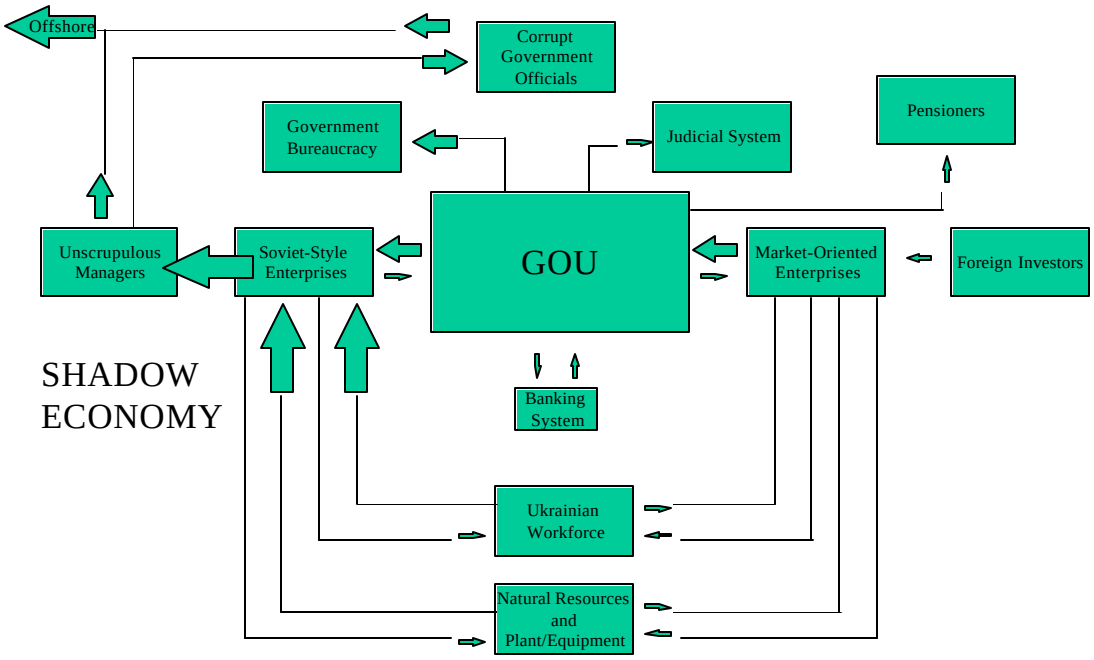
[10] President Kuchma issued three decrees numbered 1572/73/74, dated December 15, 1999, that may help the situation. The decrees appear to institute broad administrative reforms, consolidating Government agencies and thereby reducing their number from 89 to 46, and reducing the size of the Cabinet of Ministers (COM).

[11] State and local Government interference in individual industries today is so pervasive that it undermines even the best macro policies. Many bureaucrats live off of a growing number of licenses, permits and controls. Bureaucratic interference at the oblast level appears to be worse than during the Soviet period – it is certainly more chaotic as a result of the newly decentralized decision-making processes.

[12] It is important to note that, while the activities of State bodies need to be coordinated, State bodies also need to have a certain degree of independence. For example, it would be inappropriate for the COM, President's Administration or Verkhovna Rada to pressure the Securities and Stock Market State Commission (SSMSC) to register a particular securities issuance, the National Bank of Ukraine (NBU) to grant or suspend the license of a particular bank, or the State Property Fund (SPF) to sell shares to a particular buyer. These decisions must be free of politics and left completely to the agencies based on their regulatory expertise and judgement.

could be undertaken. We believe, however, that it presents a sufficient number of ideas to promote discussion among policymakers so that they can reach consensus and act. Ukraine can develop a competitive financial sector capable of mobilizing investment resources and making them available to productive enterprises, but it will require a concerted effort. The destructive dynamic, in which the failure of reforms leads to less investment, looting of enterprises, and more failure, must be reversed through bold action to implement a constructive dynamic, where reforms lead to investment and further reforms. Real reform will be reinforcing.

Current Allocation of Resources



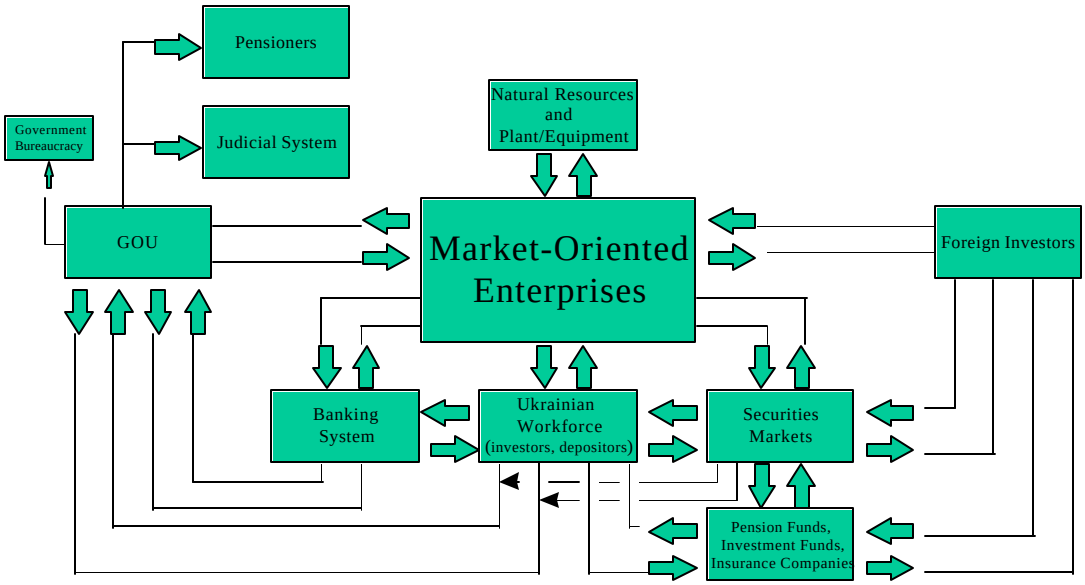
In the Ukrainian economy today the primary inputs are: the Ukrainian work force (labor) and the natural resources and existing plant and equipment developed during the Soviet era. Supplementing these primary inputs is a minimal amount of foreign investment. Capital is scarce. Non-capital inputs of production, such as energy and raw materials, are overpriced.

Resources are misallocated within the system, too often flowing to value-destroying enterprises. The system revolves around a cumbersome, self-interested bureaucracy and old Soviet-style enterprises – supported by the State through various tax breaks and other privileges – that absorb the bulk of the primary resources in inefficient production processes. Little is re-invested back into the system in the form of wages and training for the work force, development of plants and equipment, modernization and restructuring of enterprises, improved use of natural resources, or payments to the budget. Instead, there is a constant leakage of capital to offshore destinations.

The banking system and securities markets are underdeveloped and thus are not a source of capital for market-oriented enterprises. Too few budget resources are directed to areas that could grow the economy, such as infrastructure development, education, the judicial system, and so on.

Too often, the benefits of the current system flow to unscrupulous managers of old Soviet-style enterprises and corrupt officials, rather than to workers and pensioners.

Post-Reform Allocation of Resources



In a reformed economic structure, the primary inputs are expanded through improved productivity from modernization and restructuring of enterprises and training of workers. Capital is available via a banking sector that effectively collects deposits and makes commercial loans, and via robust securities markets. Collective investment institutions (pension funds, investment funds, and insurance companies) attract citizens' funds into the system and pool capital for investment. Offshore capital is brought back into the country and invested in the productive sector. Natural resources are used more efficiently, and the cost of non-capital production inputs is reduced to market levels.

Disclosure of full and accurate information results in an efficient allocation of resources by the market to value-creating enterprises. Creditors and investors make thousands of small decisions about the prospects of individual firms, which add up to an efficient overall allocation of capital. Involvement of the government bureaucracy in production and resource allocation decisions is greatly reduced.

Businesses are attracted out of the shadows and into the formal economy. Improved corporate governance leads to real restructuring and increased productivity. The judicial system enforces contracts, which leads to an expansion of economic relations and growth.

The Government receives increased tax revenues and faces a reduced cost of borrowing, and thus is able to meet its obligations to pensioners and invest in the infrastructure, educational institutions, judicial system, etc. needed to grow the economy.

The benefits of the system flow to those providing the inputs: workers (and pensioners), citizens investing in securities markets and depositing money in banks, domestic and foreign providers of capital. The Government benefits through expanded budget revenues from a broadened and strengthened tax base and increased privatization revenues. Jobs are created and standards of living increase.

2. Reinvigoration of Large-Scale Privatization

Russia and Ukraine are the two most populous countries of the former Soviet Union. After the break up of Soviet Union, Russia proceeded quickly with large-scale privatization – privatization of the largest enterprises – and the results can only be called disastrous. Rather than investment, restructuring and growth, Russia has seen massive looting of enterprises by the new "kleptocrats," coupled with dramatic capital flight. Ukraine, on the other hand, has proceeded more slowly with large-scale privatization, but has done no better. It is also crippled by massive corruption, capital flight, and eleven years of declining GDP. Thus, in crafting a large-scale privatization strategy going forward it is important to ask what, if any, lessons can be drawn from the experiences of these two countries as well as from other countries around the world that have privatized formerly State-owned enterprises.

We offer several conclusions. It is important to state up front that the overall conclusion is *not* that large-scale privatization in the countries of the former Soviet Union was a mistake or should be delayed further.[13] In fact, large-scale privatization should be accelerated in Ukraine. But it matters *how* privatization is conducted. And the *institutional framework* existing in a country matters a great deal to the success of privatization.

Privatization and Ownership Concentration Patterns in Countries around the World. The United States and the United Kingdom are unique among the countries of the world in that they have stringent shareholder protections and widely dispersed share ownership. These shareholder protections – involving laws, courts, class action lawsuits, securities regulatory agencies, self regulatory organizations (SROs), institutional investors, auditors, and hostile takeovers – are complex and took many decades to evolve. Most countries do not have such a high level of shareholder protections (Figure 2.1).[14] There are varying reasons. For some countries, the

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[13] This discussion focuses on large-scale privatization. Small-scale, and to some extent medium-scale, privatization has been a success in Ukraine and Russia. This is apparently because there are less corporate governance problems in companies in which there is less separation of ownership from control. The owners of a small firm are active in the management of the firm and can ensure that it is run efficiently and profitably.

[14] Figure 2.1, and much of the related evidence and analysis in the text, is drawn from Dyck (1999). Dyck bases his analysis on two groundbreaking studies that collected data on legal protections and ownership concentration in 49 countries.

The left axis of Figure 2.1 represents a scale where the highest possible score is 125. The scale is constructed by taking the product of three indexes. The first index measures the number of shareholder protections in a country, such as one-share-one-vote, cumulative voting/proportional representation, preemptive rights to new share issues, etc. The second index measures the quality of accounting information (with a maximum value of 90 based upon whether 90 items deemed important are included in company annual reports). And the third index measures enforcement using a "rule of law" index produced by the country risk rating agency International Country Risk.

The bottom axis of Figure 2.1 is a scale from 1 to 100, representing the average of the combined stakes of the 3 largest shareholders for the ten largest publicly-traded firms in each country. A country is classified as having a "diversified" shareholding pattern if the average stake of the three largest shareholders is less than 35 percent, and "concentrated" otherwise. This high percentage biases the results against finding a concentrated shareholding pattern.

limited shareholder protection follows from a lack of laws; for others (such as Argentina), the limitations follow from weak information disclosure and enforcement.

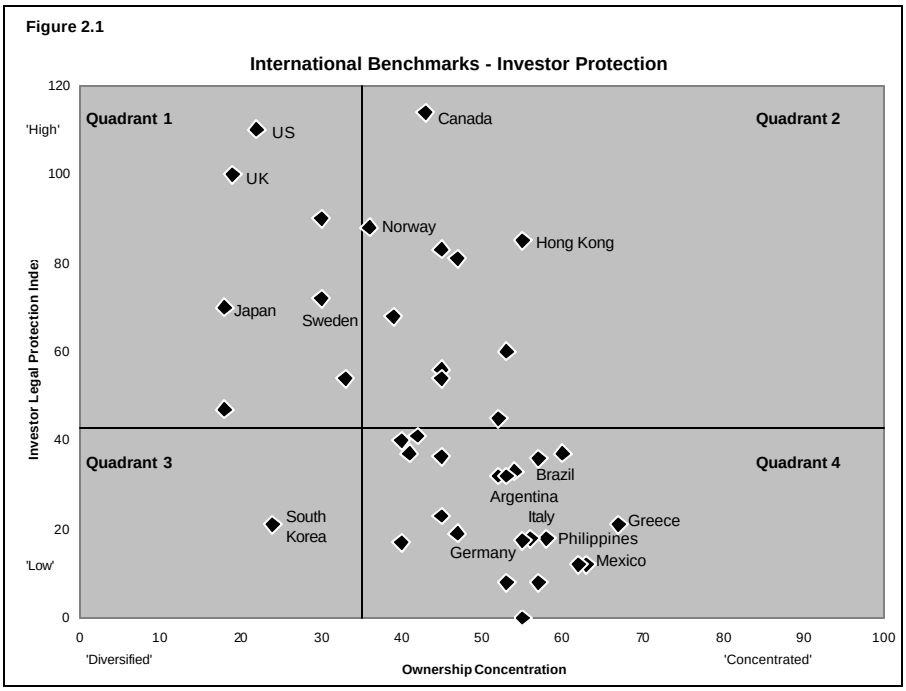
Not surprisingly, successful countries (such as Germany) with weak shareholder protections rely on ownership concentration instead to ensure good corporate governance.[15] With fewer shareholders, each shareholder has a greater incentive to monitor management. Concentrated owners often become active investors who gain access to good information, sit on supervisory boards, hire and fire managers, and participate in the company's strategic planning.[16] Complex shareholder protections are less necessary in an environment where there are such large shareholders.

Dyck relies on two studies by La Porta, Rafael, Florencio Lopez-de-Salines, Andrei Shleifer and Robert W. Vishny, entitled "Law and Finance," and "Corporate Ownership Around the World," published in the *Journal of Political Economy,* No. 6, Vol. 106 (1998).

[15] Germany also has other corporate governance mechanisms, particularly the presence of very strong creditor protections and the presence of agents with "hold up power," such as banks and workers, on supervisory boards and as owners. "Hold up power" refers to the fact that the banks can refuse to extend new loans and the workers can go on strike or exercise their authority as members of the supervisory board. These moves can effectively stop any corporate action that they believe is not in accordance with good corporate governance. Importantly, both banks and workers generally have accurate and timely information about corporate actions.

[16] It should be noted that, while it is an easier method for a country to rely on, concentrated ownership is a second best solution to the problem of corporate governance. Hence Germany's current efforts to increase shareholder protections. There are four reasons for this: i) widely dispersed ownership allows for better risk spreading; ii) widely dispersed ownership allows for greater capital formation; iii) if a concentrated owner has its own governance problems (as often occurs when the government is a concentrated owner - - a systemic problem in a command economy), then concentrated ownership simply replaces one governance problem with another; and iv) concentrated ownership increases the possibility that a dominant shareholder will use its power to abuse the minority shareholders.

Figure 2.1



Again not surprisingly, in the countries that provide the most compelling evidence that privatization improves productivity, privatization followed the shareholder concentration patterns already existing in the country. That is, the initial allocation of shares in privatization has been concentrated in countries that rely on concentrated share ownership generally for corporate governance, and dispersed in countries that rely on shareholder protections. For example, British privatizations resulted in widely-dispersed shareholdings (quadrant one, Figure 2.1) and were successful as measured in terms of increased productivity. Argentinean, Mexican and Bolivian privatizations, on the other hand, resulted in concentrated share ownership (quadrant four) and were also successful.[17]

Privatization and Ownership Concentration Patterns in the Transition Economies. Among the transition economies, privatization in East Germany, Estonia and Hungary resulted in concentrated ownership (quadrant four, Figure 2.1). Consequently, in these three countries, there have been few concerns about corporate governance, and privatization has been associated with restructuring and growth. East Germany relied on asset sales instead of share sales, with openness to foreigners and a preference for firms that had experience in the sector and a good management record. Often this meant that East German firms were bought by experienced West German firms. Estonia and Hungary's privatizations generally followed the pattern of East Germany, with domestic voucher privatization limited to 40 percent, and a 60 percent stake sold to one strategic foreign investor.

The other transition economies, Ukraine included, provide a startling contrast. Their privatizations would fall in a quadrant (quadrant three) occupied by *only one* country, South Korea, and there may well be measurement error with respect to concentration of ownership in South Korea. Thus, it seems that privatizations in

[17] Mexico, Argentina and Bolivia relied heavily on asset sales rather than share sales. Sales were usually to a single or small group of owners, almost always with a core investor. Even with share privatizations, a controlling stake was usually reserved for a core investor.

these transition economies were bound to give rise to problems. No successful countries with ineffective shareholder protections have dispersed shareholding patterns. And yet privatization in most transition economies resulted in exactly this unworkable combination.

Reformers in transition economies thought that after privatization the countries would improve their legal environment and move to quadrant one, or concentrate share ownership in the secondary market and move to quadrant four. It has turned out, however, that both of these paths are extremely difficult. Transition economy countries have remained stuck in the "no man's land" of quadrant three. The first path, improving the legal environment, would seem to be easy: simply draft and pass the necessary laws. The problem is that developing the mechanisms to ensure *enforcement* of these laws appears to take decades. The second path is equally problematic: assembling a majority stake in a company takes time and is costly in countries with poorly developed secondary markets. Broker-dealers may have to stand outside factory gates offering to buy shares from workers. If a country engages in incremental privatization it may take even longer. By the time a majority stake can be assembled, there may be little of value left in the enterprise.

Recommendations regarding Initial Share Allocation in Ukraine. Because it is so difficult to move out of quadrant three in a realistic time frame, it is *imperative* that large-scale privatization result in the correct share allocation from the beginning. That is, the initial share allocation in large-scale privatization must be in quadrant four. Such privatizations must include a core strategic investor with a majority stake. There are political reasons why this may be difficult, particularly if the emphasis is on foreign investors, but they must be overcome. Otherwise, large-scale privatization will result in continued profit skimming, asset stripping and stagnant productivity.

Some may argue that Ukraine is on the right path because, by 1997, managers owned 46.2 percent of privatized firms (Figure 2.2). This is not a reasonable conclusion, for three reasons. First, large-scale privatization is only beginning in Ukraine, so it is too soon to know what will be the ultimate shareholder concentration patterns. Second, 46.2 percent is low by international standards. As can be seen in Figure 2.1, the countries in quadrant four rely on higher concentration levels.[18] Finally, it matters a great deal who the "concentrated owners" are. There is abundant evidence that foreign owners have the most beneficial impact, and that outsider privatization significantly outperforms insider privatization.[19] In addition to infusions of capital and know-how, foreign firms generally have better corporate governance practices as well as reputations to maintain.

Figure 2.2

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[18] In fact, even higher concentration levels are required in Ukraine than are required in the countries around the world that rely on this method of corporate governance. See footnote 20.

[19] Among others, the following three recent studies have shown this: Djankov, Simeon, (1999), "Ownership Structure and Enterprise Restructuring in Six Newly Independent States," *Comparative Economic Systems*, forthcoming; Frydman, Roman, Cheryl Gray, Marek Hessel and Andrzej Rapaczynski, (1999), "When does Privatization work? The impact of private ownership on corporate performance in the transition economies," forthcoming, *Quarterly Journal of Economics*; and Havrylyshyn, Oleg and Donald McGettigan, (1999), "Privatization in Transition Economies: A Sampling of the Literature," IMF Working Paper, European II Department.

We know of no studies to the contrary.

Country	*Managers*	*Employees*	*The State*	*Outside local investors*	*Outside foreign investors*	*Individuals*
Moldova						
1995	7.2	21.6	38.6	24.7	0.3	7.6
1997	18.3	19.7	23.8	22.6	2.1	13.5
Ukraine						
1995	14.6	23.6	42.6	18.9	0.3	0.2
1997	46.2	15.3	15.4	17.7	0.9	4.5
Kazakhstan						
1995	23.1	10.7	34.8	23.6	4.4	3.4
1997	29.4	8.2	16.1	30.2	6.8	9.3
Russia						
1995	25.4	26.0	23.5	23.4	1.6	0.1
1997	36.3	23.3	14.7	21.5	3.8	0.4
Kyrgyz						
1995	28.1	38.3	12.4	16.8	2.2	2.2
1997	34.4	36.4	5.6	18.9	2.3	2.4
Georgia						
1995	41.5	9.4	41.0	4.9	1.0	2.0
1997	53.6	10.4	23.3	8.0	2.2	2.2

If the new "concentrated owners" of an enterprise are in fact the old Soviet-era directors, this will generally not result in an increase in productivity despite the concentrated ownership. On the one hand, the separation of ownership from control has been reduced – if the director skims profits and strips assets, he will only be stealing from himself. One the other hand, however, the director may not know how to run the business in a market economy. He may conclude that it is safer to stick to profit skimming and asset stripping – at which he knows he can be successful – rather than the more ambitious path of restructuring the enterprise to make it more profitable. Moreover, such a director will often be an older man, a few years from retirement. If he plows profits back into the firm, restructures and makes the firm more competitive, the benefits will come after he is gone. There is little or no tradition of passing a firm to one's children in Ukraine. And there is not a well-developed secondary securities market where he could sell his shares and recover their full value. Therefore his "rational" course may be to extract value from the firm by profit skimming and asset stripping. As a result, enterprises are not restructured, investment does not occur, and productivity stagnates.

Concentrated ownership by the "right" owners, on the other hand, can ensure that enterprises are restructured, production expanded, and that directors manage enterprises effectively. These "concentrated owners" will monitor general directors and managers and get involved in a company's activity. The goal of the "concentrated owner" will be profit maximization, but other benefits will follow such as job creation and wage increases.

But a new problem can arise – if there is a "concentrated owner," i.e., a majority shareholder with real power, how can we be sure that the majority shareholder will not take actions that are in his own interest but detrimental to minority shareholders. An effective joint stock company law that protects minority shareholders *against the actions of majority shareholders* is thus crucial. In addition, other protections may be necessary. For example, banks should be encouraged to play their proper role as monitors of corporate performance, cutting off loans and/or

forcing firms into bankruptcy if necessary to achieve proper governance. Collective investment institutions, such as pension funds and investment funds, should also play a role in protecting minority shareholders.

Pre-Privatization Restructuring. It may also be necessary to break up large enterprises into smaller units. This will automatically reduce somewhat the "separation of ownership from control" problem. Moreover, large enterprises in Ukraine are agglomerations of outdated and mismatched assets with bloated workforces and huge liabilities leftover from subsidies directed to the firm in the past. Such enterprises are not likely to attract investors.

The Problem of Size

The well recognized failures of central planning – having at least in part to do with the inability of the central planner to gather and disseminate relevant information – can apply with equal force within a large organization.

Joseph Stiglitz, World Bank Chief Economist, on the importance in post-Socialist countries of restructuring large enterprises to decentralize decision making.

Recognizing this, Governments in the transition economies, Ukraine included, are taking steps to restructure and down-size large enterprises before privatization, at a minimum cleaning up balance sheets and reducing labor problems. These efforts should be encouraged. But Governments traditionally are not very good at restructuring. In Ukraine, given that most enterprises are technically insolvent, the answer may lie in the new law "On the Restoration of Solvency of the Debtor or Declaring it Bankrupt" (Box 2.1). Pursuant to this law, professional bankruptcy trustees can develop rational restructuring plans that will break enterprises into smaller, more valuable units and maximize value for the creditors. These smaller units can then be privatized to foreign strategic investors for whom this more logical grouping of assets fits their business plan. The involvement of the bankruptcy trustees will "depoliticize" the role of the branch ministries and the State Property Fund (SPF); privatization proceeds will be enhanced and productivity overall should increase.

Conclusions Regarding Large-scale Privatization. To summarize, a decade of post socialist transition allows the following conclusions to be drawn regarding large-scale privatization:

- It is only where privatization is associated with good corporate governance and restructuring that there is a positive impact on growth;
- In a country such as Ukraine with a weak legal system and, in particular, poor shareholder protections, the initial share allocation should be highly concentrated, with a core strategic investor receiving *at least* a majority share;[20]

[20] Considerably more than a "50 percent plus one" majority would be desirable. Controlling 50 percent plus one share of a company does not give a strategic investor much comfort. General shareholder meetings are well attended in Ukraine, and therefore more shares are required to have a majority at a particular general shareholder meeting. In addition, under current legislation as well as under the draft law "On Joint Stock Companies", changing a company's charter or passing a decision to spin-off social assets requires a 75 percent majority, a high threshold by institutional standards. Of course, less than 75 percent will suffice at a general meeting where less than 100 percent of the shares are represented, or where some minority shareholders can be persuaded to vote with the strategic investor, but we believe that the percentage tendered to a strategic investor should be closer to 75 percent than to 50.

- Incremental privatization is not the optimal approach because it then requires a great deal of time to assemble a controlling block of shares and the value of enterprises deteriorates in the meantime;
- Privatization will be most effective if the core investor is not current management, but rather an outside investor with experience in the sector, a good management record, a strong reputation to maintain, and its own good corporate governance practices. Care must be taken in screening bidders, however, because an honest bidder may offer less money for an enterprise than a dishonest one. This is because the honest bidder has to do the hard work of restructuring the enterprise to make it profitable, while the dishonest bidder has a competitive advantage in that he can evade taxes, obtain favors from the Government, "cheat" when fulfilling investment obligations, engage in price-fixing, enforce contracts through force rather than the court system, not pay workers, and engage in profit skimming and asset stripping;
- Large-scale privatization into a market without a comprehensive law on joint stock companies is dangerous. The law on joint stock companies must have strong provisions – particularly those that protect minority shareholders from potential abuses by strategic investors (strategic investors themselves can protect shareholders generally from abuses by management).[21] The charters of privatizing enterprises should have strong shareholder protections as well;

[21] Consideration could also be given to privatizing companies as limited liability companies rather than joint stock companies. Limited liability companies may be more appropriate for "close corporations" having a large shareholder and a limited number of total shareholders.

Box 2.1

Creditors' Role in Corporate Governance and Restructuring:
Can Creditors Succeed where Others have Failed?

In the nineteenth century, most firms had only a single owner-manager. There was no problem ensuring that the manager of a firm acted in the interests of the firm's owner – the manager was the owner.

With the rise of the modern corporation arose the problem of "corporate governance" – how to ensure that the managers of a firm act in the interests of the company's owners, the shareholders, who are not actively involved in the daily operations of the firm. Or more broadly, how to ensure that the managers govern the firm properly in the interests of the "stakeholders" – i.e., shareholders, creditors, employees, suppliers, customers, and society at large. Owners who are not involved in management have imperfect information about a firm's operations. Unless they own a large percentage of the company's shares, it may not be worth their time to obtain that information and oversee the managers. Moreover, if one owner expends effort overseeing the managers, all the other owners get to "free ride" on his efforts. These problems give rise to the need for some model of corporate governance that will ensure that managers govern firms effectively.

In Ukraine and the other formerly-socialist countries of the region, finding an effective model of corporate governance is particularly important because extensive restructuring of enterprises is necessary to modernize them to operate for a market economy. Current managers are often not able or willing to make the necessary changes on their own. They may not have the skills necessary for a market economy. Or they may simply conclude that it is more profitable to focus on finding ways to extract value for themselves. Moreover, many enterprises in the formerly-socialist countries are simply too large, with inefficient groupings of assets, loss-producing product lines and excess workers. Such enterprises require radical, painful restructuring that current managers are unlikely to undertake.

So what model of corporate governance can accomplish the radical restructuring needed in Ukraine? There a several models in countries around the world. One possibility is the "Anglo-American" model – provide strong shareholder protections and require full and accurate disclosure of information. This allows for widely-dispersed shareholders, which is an advantage in terms of risk spreading and capital formation. But only two countries in the world follow this model– the United States and Britain – in part because such protections are extremely difficult to develop and implement.

A model potentially more suitable for transition economies is the "German model" where large banks play an active role in corporate governance as owners and creditors. Banks can overcome the information disclosure problem by relying on accumulated knowledge of their customers' businesses based on close interaction. And banks have considerable leverage over management, particularly where companies rely on short-term loans that must be "rolled-over" frequently. It is often not easy to find an alternative source of credit if a company's primary bank refuses to extend further loans. Finally, banks have a strong incentive to oversee managers in order to ensure proper governance and repayment of debt.

This "German model" will not work in Ukraine, however, because the banking sector is woefully underdeveloped. Banks under the former socialist system were not banks at all in the Western sense. They did not screen and monitor borrowers; they simply allocated credit as directed by the Government. Moreover, the Ukrainian banking system is tiny as a percentage of GNP. Developing a modern, well-capitalized banking system in Ukraine will simply take too long for this to be a viable corporate governance model.

Reformers in the formerly-socialist transition economies initially hoped that voucher funds would play the dominate role in corporate governance. Fund managers hold relatively large positions in companies and therefore should have the incentive and the ability to obtain information about a company's activities, oversee managers and implement needed restructuring. Those funds that do a good job will increase returns and attract more investors. Unfortunately, this has not happened. With a few notable exceptions, voucher investment funds in Ukraine have not been particularly interested or effective at achieving restructuring of the enterprises in their portfolios. The evidence from the Czech Republic, which is further along in large-scale privatization, is even worse. Voucher funds provided a vehicle for high powered abuse. Managers diverted value to themselves in a process called "tunneling." Performance of companies in the funds did not improve. And the fact that the funds were closed-end made the situation worse – with open-end funds investors would have been able to withdraw their money and thus provide a check on abuse by managers.[1] In sum, the "voucher privatization fund model" of corporate governance has not proven to be particularly successful.

The most promising corporate governance model for the transition economies seems to be reliance on "concentrated owners" – foreign strategic investors who "import" good corporate governance practices from their home countries. If they have large enough blocks of shares, such strategic investors will have the incentive and the ability to oversee managers, restructure companies and increase productivity. The model is not perfect – one problem is that these large shareholders may abuse their power to the detriment of smaller shareholders. At least in the Czech Republic, the market value of companies generally plummets when a single party gains control, reflecting the market's view that control is more often associated with asset stripping than with increased productivity.[2] Nonetheless, large strategic investors coupled with strong protections of minority shareholders would appear to be the best corporate governance model for the countries in transition. The difficulty is that enterprises often need to be restructured in advance of privatization *in order to attract* the right strategic investors. Qualified strategic investors may not be interested in purchasing controlling stakes in the large, sprawling enterprises that were created during the Soviet period.

Which brings us to creditors. Ukraine recently passed the Law of Ukraine "On the Restoration of Solvency of the Debtor or Declaring it Bankrupt." This law might provide the method needed to restructure enterprises, clean up their balance sheets and break them into smaller units that can be effectively privatized to qualified strategic investors.[3]

The new bankruptcy law expresses a clear preference for reorganization rather than liquidation, which is an important improvement over the old law. First, under current market conditions it is difficult in liquidation to find buyers for assets at reasonable prices. Second, liquidation results in job losses and the destruction of "organizational capital." It is more difficult to organize new companies from scratch than to reorganize existing ones, particularly in a country without an entrepreneurial tradition.

Most enterprises being privatized are technically "insolvent" and thus are candidates for reorganization pursuant to the bankruptcy law. They generally have four main creditors: i) the State budget; ii) the Pension Fund; iii) workers; and iv) enterprises in the energy sector. The new bankruptcy law will allow trained professional bankruptcy trustees, trained and licensed by the Agency for Bankruptcy Affairs, to restructure enterprises. This process has several advantages:

- The role of the SPF will be depoliticized, and the whole process will be more transparent;

- Creditors will be in control, subject to oversight by the arbitration court to ensure that the process is fair. The procedures for creditor approval are simple and clear (a debt-weighted majority vote by all of the unsecured creditors is required for each decision). This is appropriate – if a company cannot satisfy its obligations to creditors in a marketeconomy it is the creditors that decide the fate of the company;

- The law includes a wide variety of methods to reorganize debtor companies and restore them to financial health and provides powerful tools for trustees to accomplish this task, including: i) closing down unprofitable production lines; ii) changing lines of business; iii) terminating employees (and borrowing money to cover severance pay); iv) selling off assets or selling an entire business as a "going concern"; v) deferring and restructuring debt; vi) debt for equity swaps; vii) collecting receivables; and viii) attracting an outside investor; and

- The law provides various methods for a debtor company to generate internal capital (retained earnings) to fund a reorganization and modernization. This is crucial because it is often difficult to find an outside investor willing to inject fresh capital.[4]

The new bankruptcy law will not function properly unless it is accepted and used. Its success will depend upon competent judges, trustees, lawyers and appraisers, as well as the Agency for Bankruptcy Affairs, the SPF, local authorities, creditors committee representatives, debtor's employees representatives and debtors themselves. Time will tell whether this new law will play an important role in corporate governance and corporate restructuring in Ukraine

[1] Our evidence regarding Ukraine is based on the opinions of various domestic and foreign specialists who have been working with companies and funds since mass privatization began. The evidence regarding "tunneling" in the Czech Republic has been well documented elsewhere. See Black, Kraakman and Tarassova (1999) for a discussion of the various studies.

[2] Stiglitz (1999).

[3] Lawmakers, State officials and judges must be vigilant to ensure that the bankruptcy process cannot be manipulated by creditors, debtors, trustees or judges. As this Paper was being finalized, BP Amoco in Russia was publicly accusing the Tyumen Oil Company of illegally manipulating the bankruptcy process to buy the Chernogorneft unit of the bankrupt Sidanko oil company. Whether or not this is true, it serves as a reminder that the process must be closely watched.

[4] The mechanisms that can help a debtor generate and retain internal capital include the following provisions:

i) all tax debts more than two years old are written off and the debtor is given six years to pay off tax debts from the most recent two years (Art. 36);

ii) clear procedures by which the debtor can reach agreements on debt restructuring with individual creditors or all creditors as a group ("amicable settlement agreements") (Art. 35-39);

iii) a debt "moratorium" – i.e., a suspension of the debtor's obligation to pay debt incurred before initiation of the bankruptcy proceedings (except the following specific debts: wages, alimony, life and health damages and royalties) (Art. 12);

iv) the Trustee has the power to reject contracts entered into by the debtor before initiation of the bankruptcy proceedings if they are unprofitable, long term, or will interfere with the debtor regaining solvency. The contracting party may file a claim for damages in the bankruptcy case (Art. 17.10);

v) the Trustee may petition the court to declare null and void agreements concluded at any time prior to the filing of the bankruptcy petition with " interested persons" of the debtor or agreements concluded within the six months prior to the ruling on sanation that give preference to one creditor over others (recovery of "preferential transfers"). Everything received by the other party pursuant to the agreement must be returned to the debtor. These rules are crucial because they prevent some creditors from gaining an advantage at the expense of others, and they provide a remedy if insiders attempt to remove assets improperly when they know that the company will soon be bankrupt (Art. 17.11);

vi) the debtor's social assets can be transferred to local authorities (Art. 26.1);

vii) money can be raised by selling a part of the debtor's assets or selling all of the debtor's assets as a "going concern" – i.e., as a functioning business with at least 70% of the current employees' labor agreements remaining valid (Art. 19-20); and

viii) the debtor is authorized to borrow money post-petition, where necessary (Art. 1: "sanation", 37.4).

In addition, passage of the proposed comprehensive law "On Securing Performance of Obligations with Movable Property," would increase the debtor's ability to obtain post-petition loans by providing lenders with collateral to secure the loans.

- There must be a tight correlation between ownership and control of companies, otherwise those in control will have an incentive to divert profits and assets to their private benefit. Pyramid structures, cross-holdings, circular ownership structures, and deviations from one-share-one-vote rules should be discouraged; and
- Consideration should be given to breaking large enterprises into smaller units before privatization, perhaps through the procedures of the bankruptcy law. At a minimum, balance sheets should be cleaned up and labor forces trimmed to make enterprises more attractive to investors.

Privatization in Ukraine since Independence. Although Ukraine began privatization soon after independence, overall the country has undertaken an incremental approach to strategic privatization with an emphasis on preliminary institution building. For example, the Securities and Stock Market State Commission (SSMSC) was created relatively early in the process (1995), in contrast to neighboring countries like Russia and the Czech Republic.

From 1992-94, a significant number of strategic enterprises were privatized through management and employee buy-outs of companies that they had been leasing from the State. Subsequently, from 1995-98, Ukraine carried out an ambitious voucher privatization program modeled on the one implemented in Russia. This involved both preferred sales to employees and managers in exchange for privatization and compensation certificates and cash, and open sales for privatization and compensation certificates via certificate auction centers. Unlike in Russia, enterprise directors in Ukraine were limited to a preferential purchase of only five percent of shares for certificates plus an additional five percent for cash if they fulfilled the conditions of their SPF-approved privatizing plans. More than 46 million citizens (98 percent) picked up their property certificates and more than 30 million citizens invested them, either directly or via investment companies and funds. Beginning in 1998, the SPF announced a new policy of cash privatization, designed to sell State assets through monthly cash auctions, stock exchange sales, and open tenders.

To date, Ukraine has privatized more than 80 percent of its medium and large enterprises and nearly all of its small-scale enterprises. However, Ukraine has been slow to privatize its largest "strategic" enterprises. Moreover, the Government continues to exert formal and informal influence over the more than 9500 medium/large enterprises privatized since 1995. The Government of Ukraine (GOU) has announced its intention to greatly speed up large-sale privatization in 2000.

The Privatization Program for 2000. The discussion of corporate governance models and privatization results from other countries around the world shows that Ukraine needs to attract qualified foreign strategic investors as it implements its ambitious privatization program for the year 2000. Only then will privatization result in increases in productivity and improvement in the economy. Those responsible for the draft "State Privatization Program for 2000" appear to understand these principles. The stated objectives of the program include:

- "attracting capital for development and restructuring of the economy;
- creating conditions for the emergence of private owners who have a long-term interest in developing privatized enterprises and managing them efficiently;
- establishing conditions of privatization that will interest international investors in Ukrainian enterprises;

- guaranteeing transparency of information regarding assets undergoing privatization; and
- generating proceeds for the State budget of Ukraine."

Even more encouraging, the draft plan 2000 specifically seeks "concentration of ownership" in order to achieve a higher level of responsibility on the part of new owners, and seeks explicitly to sell "controlling stakes" in Ukraine's largest enterprises to industrial investors. As we have seen, this is exactly what the evidence from other countries suggests is needed. "Controlling stakes," however, must mean 50 percent plus one *at a minimum*. Ukraine has lost the *confidence* of strategic investors. What might have worked 5-7 years ago, will not work in 2000. Qualified investors will invest in Ukraine today only if they can purchase a majority stake of an enterprise.[22]

The plan 2000 includes a troublesome system of "rewards" and "punishments" for investors. If a buyer meets all obligations in the first three years, he has the right to purchase the State's remaining shares. On the other hand, if the financial situation of a company has worsened because of the investor's inactivity, the State can legally take back the investor's shares and claim damages from the investor for harm caused to the enterprise. A court is to make this determination. This attempt at an innovative device may simply doom the privatization effort as far as foreign investors are concerned. Serious investors have little reason to trust the Ukrainian State. Thus, the State should rely on better screening and pre-qualification of bidders and not retain 25 and 50 percent share packages at all – at a minimum, such share packages are a constant reminder that the State still wants to control corporate outcomes.[23] In addition, this system of "rewards" and "punishments" ensures that the privatization regime will be extended for at least three additional years, when privatization should in fact be accelerated. Enterprises should be subject to the privatization regime – in which certain norms of the laws "On Enterprises" and "On Business Associations" do not apply and the enterprises are not subject to bankruptcy and reorganization – for not longer than one year.

The 2000 privatization program should also contain a requirement that the charters of companies going through privatization contain shareholder protections, such as cumulative voting and required shareholder approval of major transactions and interested person transactions.

In sum, the draft 2000 privatization program contains some attractive features that are in keeping with evidence from other countries around the world regarding the methods of privatization that result in increased productivity. But it may be fatally flawed if strategic investors are not offered majority stakes. The plan should be revised and then implemented next year in a way that actually achieves the market-oriented language of the plan.[24]

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[22] Missteps and problems in Ukraine to date have created a situation where an investor purchasing less than a majority share of an enterprise will discount the investment so drastically – to balance the perceived risk of investing in Ukraine – that the State will be unable to sell the enterprise for its "true" value (or to sell it at all, given minimum bid restrictions). The only way to reduce this discounting by investors is to sell majority controlling blocks.

[23] Equally ill-conceived and counterproductive are proposals for the State to retain a "golden share" in certain attractive enterprises, such as Ukrtelecom, providing veto power over major decisions.

[24] The SPF and Energy Ministry agreed in November 1999 to a relatively aggressive schedule for further privatizing energy distribution companies through tenders in 2000. Encouragingly, the plan provides that some tenders will employ the services of an investment bank, and some tenders – not

Attracting Foreign Strategic Investors to Ukraine. As we have seen, attracting qualified foreign strategic investors to Ukraine is crucial for good corporate governance. A more pressing reason for attracting such investors next year is that the GOU must raise significant proceeds from privatization to avoid defaulting on its foreign loan obligations and to meet its budget needs. The GOU has stated that is wants to raise Hr 2.5 billion from privatization in 2000, more than four times what it raised in 1999. Finally, Ukraine must attract strategic foreign investors because its largest enterprises are losing value from lack of such investors injecting modern technology, manufacturing expertise, marketing skills, business plans and solid management. None of the industrial "giants" – enterprises with more than Hr 750 million ($150 million) in assets – have been privatized to an extent that allows for effective control by private owners.

Greater foreign direct investment is possible, as other central and eastern European nations have demonstrated. Unfortunately, Ukraine's reputation in the international investment community has been tarnished by past publicized irregularities with privatization tenders.[25] As a result, foreign participation in privatization has been negligible given the size of the Ukrainian industrial sector. With the notable exemption of the tobacco industry, no other industry has experienced serious inflows of foreign capital.[26] Ukraine is in a position where it must take *dramatic action* in order to alter the perceptions of international investors.

Showcase Tender. We recommend that Ukraine use the privatization of a major State-owned enterprise (for example, Ukrtelecom, Donbasenergo, Motor Sich, Mykolayiv Alumina, or a similar prominent enterprise) as an international "showcase"

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necessarily the same ones – will offer controlling (50 percent plus one) share packages. The picture has been clouded since that announcement, however, by the SPF's December 6th Order No. 2289 canceling the sale of State-owned stakes through exchanges and PFTS "due to difficulties in power supply in the winter period, the necessity of establishing effective control by the State over the operation of power companies, and restructuring of the sector." Analysts concluded that Order No. 2289 also applies to the planned tenders. This flip-flop, of course, continues the (almost complete) erosion of investor confidence in the Ukrainian State.

[25] Problems involving privatization tenders that have received wide publicity include the following: price floors have been set so high that investors are not willing to buy the shares offered; the rules of the tenders are constantly being changed; the SPF is unable to guarantee full shareholder's rights to investors following the sale (e.g., Lafarge's purchase of shares of MykolayivCement); the GOU (or another large investor) finds ways during the privatization of an enterprise to strip away the best assets; multiple privatization plans are drawn up and then canceled (e.g., Mykolayiv Alumina Plant); investors do not compete on a level playing field because certain bidders agree to unrealistic investment commitments, only to fulfil those commitments using cash substitutes or other methods not requiring the investment of real assets (encouragingly, SPF is getting tougher on such actors); investors failing to pay for share packages they purchased via tender (e.g., the failure of AMP to pay Hr 52 million for a 25 percent stake in TurboAtom it purchased in a tender last summer); and well-connected Ukrainian entities submit bids only nominally higher than international investors' bids– indicating an obvious leak of information– and then attempt to immediately sell the investment to the international investors at much higher prices.

[26] There is a false perception among some Government officials that the aim of major foreign investors is to restrict the ability of local enterprises to compete in certain "targeted" industrial sectors. The irony of this view is that most of the competing products in these sectors are entering Ukraine from neighboring countries where enterprises have been revitalized by capital and "know-how" from the very foreign investors of which the Ukrainian Government officials are afraid. (Booz Allen and Hamilton (1999)).

that demonstrates a fresh market-oriented commitment by the GOU.[27] This is more difficult in the wake of the Asian and Russian financial crises, but Ukraine – with a moribund economy stuck half way between command and free market – is not in a position to wait until a more auspicious time. The elements of this effort could include the following:

- Before launching the international tender, the GOU should establish very clear objectives for this method of privatization and define clear criteria for selecting the entities worth offering through international tender.
- The objectives of such a program should be based on a national strategy to develop particular sectors. The program should provide support for the "flagships" (e.g., telecommunications, natural monopolies, chemicals or energy) of the national economy with direct hard currency and know-how infusions that create a firm base for their further development.
- The SPF's responsibility for the tenders should be de-politicized so that its role is that of a professional sales agent acting on behalf of the GOU rather than a political body.
- An unwavering set of rules should apply, in accord with accepted procedures for international tender offers, honored by Ukraine without any unreasonable amendments or changes to the procedures once enacted.
- The international tender offer should be open to any *qualified* bidder,[28] foreign or domestic.
- The international tender should be based on a third-party asset evaluation of the enterprise by a world class investment bank or accounting firm.[29]
- This evaluation should be used to establish a "reserve minimum" price that is internationally acceptable, which sets a legitimate price floor for the sale and thus protects Ukraine from any attempted under-market purchase.

Polish Telecom Privatization

Despite acrimonious circumstances, the Polish Government decided to go forward with the planned privatization of TPSA (Polish Telecom) and was fully rewarded. The November 18, 1998 flotation of a 14 percent stake in TPSA on the Warsaw and London stock exchanges was the largest IPO in Central and Eastern Europe to date. The IPO almost doubled the Warsaw Stock Exchanges' market capitalization to $21 billion.

Emerging Stock Markets Factbook, 1999

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[27] Attracting foreign investors will require convincing them that there will be a stark reduction in the control retained by branch ministries and an overall reduction in the Government's intervention in the daily operations of enterprises. Investors must be convinced that there will be a "level playing field" where companies in which they invest will not be required to compete with enterprises receiving concessions from the Government.

[28] Pre-qualification of bidders in privatization tenders conducted in Ukraine has proven to be crucial. There have been cases when, due to inadequate pre-qualification procedures and unclear tender rules, the SPF has been forced to sign sale contracts with entities which obviously have no industrial experience or financial capacity to develop the acquired business.

[29] Despite the fact that the State has declared in various laws – including the 1996 law "On Foreign Investment" – its intention to attract foreign investment into the Ukrainian economy generally, and the privatization process specifically, international privatization tenders still involve various difficulties. This is especially true with currency regulation – from restrictions on paying non-resident investment banks in hard currency for their services, to failure to return hard currency performance guarantees to foreign tender participants in a timely manner. Such practices substantially increase the problems and risks associated with participation in international tenders and scare away foreign investors.

- The competition should involve only commercial tenders.
- There should be no barriers to any business restructuring that the new majority owner may wish to implement.
- As a first step, a small amount of shares (e.g., 5 percent) can be sold, by any method, and the enterprise listed on an exchange or electronic stock market in Ukraine to establish a secondary market price.[30]
- A majority interest in the enterprise should be tendered (preferably 75 percent) to the successful bidder to demonstrate a "no-meddling" commitment by the GOU.
- The tender should include a commitment by the GOU to sell the entire remaining share interest through the Ukrainian securities markets. The State should be willing to relinquish or alienate control completely.
- The legal grounds for unsuccessful bidders to challenge the integrity of SPF decisions and procedural discrepancies should be minimized so that the right to challenge the results of a tender (and liability for ungrounded claims) is balanced with the SPF's powers to alienate State property.
- The legislative requirements for the international tenders should be made consistent with the above-mentioned program. This adjustment would require only minor changes to legislation.

Further International Tenders: It must be stressed that the overall approach to tendering Ukrainian companies to foreign investors needs to be radically changed. Privatization of State property should be conducted quickly, according to simple, clear procedures. Certainly the transparency of the process needs to be increased. And instead of the traditional emphasis on retaining State control over so called "strategically important companies," the GOU should look at the international tender process from the investor's viewpoint. The companies offered must generate active interest among international investors. Only a few companies, filtered through fairly elaborate selection criteria, will generate the necessary interest. International tenders should be undertaken only for these few very attractive companies; the companies that do not meet the established selection criteria should be offered through less expensive and painstaking methods. The "strategically important companies" are *exactly* the ones that should be offered because they are the ones that will attract investors and they are the ones into which it is most critical that foreign capital and know-how be injected.

The GOU (or a special selection committee of top decision-makers from the Verkhovna Rada and the Presidential Administration) should require that the relevant branch ministries submit lists of enterprises in their sectors that meet the selection criteria, and then it should decide which enterprises from these lists can be offered to foreign investors. Once that decision has been made, neither the branch ministries nor any other State authorities should have the power to interfere with the SPF's efforts to tender the enterprise. At that point, the SPF should have complete ownership over the relevant State assets.

The business potential of the companies and their investment needs should be thoroughly investigated and analyzed, so that realistic values are established.[31] Typically, the analytical capacities of the SPF and the branch ministries managing State-owned assets are insufficient to perform this work quickly and accurately – thus

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[30] It should be recognized that this market will be illiquid and thus the secondary market price will not necessarily reflect the ultimate purchase price.

[31] The process of indexation and increasing statutory funds must not be allowed to interfere with the SPF's ability to quickly privatize State enterprises.

the need for the services of professional investment bankers and international financial consultants for the most promising tenders. Such international advisers are also needed to help the SPF conduct pre-privatization restructuring to make enterprises more attractive to investors. Governments of all countries hire investment bankers and financial consultants to assist with privatization. The GOU needs to realize that organization of international tenders is costly, but that the results of successful tender sales can be impressive.

The resistance of the ministries and other State agencies, which have been managing these enterprises for decades, to privatization of the assets will only grow stronger if the tender program fails to demonstrate immediate positive results. The bureaucracy will block alienation of the assets in any way possible to preserve their powers. That is why it is crucial that the process move forward quickly and competently. Where management of an enterprise is unwilling to privatize, the SPF should be given powers to correct the situation. When the management does not complete pre-privatization restructuring and preparation for the international tender in due time according to the privatization program, the SPF should have the power to change the management.[32]

With such dramatic steps, Ukraine can potentially recapture its lost opportunity to obtain foreign direct investment of needed capital and know-how.

State Holding Companies. Five years after initiating privatization, the State's first instinct remains to own and manage enterprises rather than to seek strategic investors and turn over control. A prime example of this was the failed compensation certificate scheme in September 1998 that would have transferred shares in some of Ukraine's largest industrial companies to a quasi-Governmental holding company originally formed in 1995, the Ukrainian State Credit Investment Company (Derzhinvest). That scheme failed, but the story is not complete. Currently, Derzhinvest and another quasi-Governmental holding company, FinProm, own all of the compensation certificates that were not claimed by citizens, representing approximately 70 percent of the total. There is pressure on the SPF to hold a final compensation certificate auction. Derzhinvest and FinProm essentially would be awarded whatever enterprises are offered (it remains to be seen if the "crown jewels" will be offered). It is unclear who stands to benefit from these schemes, but, to put it mildly, "privatizing" attractive enterprises to quasi-Governmental holding companies is not likely to help develop the environment of *confident expectations* needed to increase investment in Ukraine. Derzhinvest and FinProm should be liquidated, and the compensation certificates canceled.[33]

NAMSCR. Similarly, the National Agency for the Management of State Corporate Rights (NAMSCR) was created by Presidential Decree dated July 7, 1998 to ensure the effective management of the State's corporate rights and generate

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[32] In general, creative methods are needed to ensure management's performance pre- and post-privatization. The most obvious is to directly tie management's compensation to the net income of the enterprise as shown in the company's financial statements. This would have the added benefit of providing an incentive to report "shadow" activity.

[33] As this Paper was being finalized, the COM issued Resolution No. 2277, dated December 11, 1999, requiring Derzhinvest and FinProm to return the compensation certificates to the Oschadniy Bank and the national insurance company Oranta, to be cancelled.

How to Attract Technical Knowledge through Trade and Foreign Investment – and How Not to

Openness to world markets makes it easier to acquire international technology, capital goods, and ideas that promote economic growth. A study of the factors driving economic growth in 130 countries found a statistically significant, positive relationship between growth in GDP per capita and the ratio of export plus imports to GDP. In another study, exports of fast-growing economies averaged 32 percent of GDP; in the slower-growing economies that figure was only 20 percent. One of the prime reasons for the growth spurt of the East Asian economies was their ability to build strong links with world markets and acquire the technology flowing through them. They accomplished this with policies ranging from complete liberalization (in Singapore, for example) to aggressive export promotion (in Korea).

Productivity growth and economic growth also come from openness to the foreign ideas and technology associated with foreign direct investment. Inviting foreign banks into a country, in particular, is often a strong catalyst for change and growth. Hong Kong, Indonesia, Malaysia, Singapore, Taiwan, and Thailand have been particularly welcoming to foreign direct investment, and their growth spurts have been closely associated with surges in foreign investment. These inflows can be attributed to a hospitable environment for foreign investment, along with favorable external conditions.

The opposite has been true in the Middle East and Africa. Countries there have received very little foreign investment, as a result of several impediments:

Lack of secure property rights, a critical element of a market-friendly institutional environment;

Severe restrictions on the ownership of business by foreigners (and excessive regulation generally);

Weak infrastructure, and

An unhealthy macroeconomy, with chronically high fiscal deficits, high and unstable inflation, and fluctuating growth rates.*

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* World Development Report, p. 29.

revenue for the State budget by exercising those rights. As of November 15, 1999, share packages of approximately 3000 enterprises had been transferred to NAMSCR's management. Creating NAMSCR was clearly a mistake. Its very existence serves to perpetuate the Government's role as a participant in the economy. The focus should be on finding effective new owners, not on managing the State's corporate rights. Retention of blocking minority stakes creates an adverse investment climate and scares away serious investors. Moreover, it is inevitable that NAMSCR will slow the privatization process – successful, complete privatization of enterprises will result in a loss of influence and eventually a loss of employment by the agency's personnel. The Government appears to be refusing to give up its previous central planning role and turn over the economy to the private sector. Trying to balance halfway between a command and a free economy, however, is a recipe for disaster.[34]

All of the "equity games" being played with State shares of enterprises continue the Government's role in the economy, allow management of State shares to be used for political purposes, encourage fraud, and stifle true economic growth.

Perhaps most egregiously, NAMSCR has transferred (in a non-transparent fashion) management of State shareholdings to State bodies and local oblast administrations.[35] This practice perpetuates the "Gosplan mentality" of Government officials intent on controlling economic activity in their spheres or geographic regions. NAMSCR also auctions off the right to manage State shares to businesses for a tiny fraction of the value of a given enterprise.[36] The problem here is a *separation of ownership from control*. If someone can obtain temporary control of an enterprise for a tiny fraction of its true cost, there is a great danger that he will improperly try to extract value from the enterprise while he has control. The danger is reduced when NAMSCR sells the right to manage the shares to a business that already owns a large block of shares – at least this person will be (partially) stealing from himself if he loots the company – but even here the danger of looting is increased. Ownership and

[34] Ms. Ewa Freyberg, a member of the Polish Parliament, stated at a conference in Moscow on June 2, 1999 that Poland, which still owns stakes in approximately 2,000 companies, plans to privatize all State property by 2003. She noted that State management of property is generally ineffective— the State has poor information, insufficient staff, and inadequate incentives to monitor representatives. The result is ad hoc corporate governance where the State intervenes only when forced to by a workers' strike, the initiative of a minister, or for some other pressing reason. Ms. Freyberg also noted that the State cannot effectively regulate and manage property at the same time.

[35] The situation in Dnipropetrovsk may be the most harmful. By Presidential Decree No. 19/99, dated June 16, 1999, and other legal acts such as COM Resolution No. 937, dated September 8, 1999, the State has transferred en masse State-owned shares in major enterprises to the Dnipropetrovsk oblast administration for management. The stated logic is that, by shifting authority to better-informed local authorities, share management can be optimized. Local authorities can better find qualified managers to run enterprises. Predictably, the rival Donetsk oblast administration soon after declared its intent to create closed production cycles in the Donetsk region for the duration of this "Dnipropetrovsk experiment." Meanwhile, certain officials at the Industrial Policy Ministry in Kyiv lament the demise of the "branch principle" and the loss of control to the regions. The larger point seems to be missing – that all of these "equity games" continue the Government's role in the economy, allow management of State shares to be used for political purposes, encourage fraud, and stifle true economic growth.

[36] Advisers involved in the process tell us that there appear to be essentially two types of purchasers buying these rights from NAMSCR: i) legitimate businesses participating in a joint venture with the State enterprise in question, or that already own some shares of the State enterprise, who buy the rights to ensure that they are not purchased by the "wrong" person, and ii) businesses that buy the rights specifically in order to cannibalize the enterprise.

control must be tightly aligned. Lending out management of State shares contradicts reform.[37]

The good news is that, as this Paper was being finalized, the President issued three decrees numbered 1572/73/74, dated December 15, 1999, instituting what appear to be broad administrative reforms: consolidating Government agencies and thereby reducing their number from 89 to 35; reducing the size of the COM; and liquidating NAMSCR and transferring its functions to the SPF. This is an encouraging step, although it remains to be seen whether the overall size of the Government will be reduced and its grip on the economy loosened. It also remains to be seen whether the "equity games" being played with management of State shares will cease, or simply be transferred to the SPF.

Eliminate Non-Commercial Tenders. Non-commercial tenders should be eliminated entirely.[38] They are inevitably non-transparent and open up the possibility that winners will be chosen based on relationships, bribes, and so on.

Proceeds of Privatization. At a minimum, it is recommended that an enterprise be able to write-off its stale debts to the Government and back wages in proportion to the money the national budget receives in a tender. This "fresh start" will clean up the enterprise's balance sheet and encourage investors to participate in the tenders.[39] The new bankruptcy law provides a number of restructuring tools that could be used both to clean up the balance sheet and restructure the debtor's operations before or in connection with privatization, increasing the value of the enterprise to investors and thus the amount received by the State.

Corporate Prototypes Seeking Capital. Certain private sector enterprises in Ukraine have successfully concluded agreements with foreign businesses that have made substantial investments in the enterprises in exchange for equity stakes. For example, the L'viv Confectionery Company, Svitoch, concluded an agreement with Switzerland's Nestle for the sale of 32 percent of its shares for $40 million. With the infusion of this capital from Nestle, Svitoch intends to modernize its production facilities and increase output. The GOU should analyze these various Ukrainian enterprises that have successfully obtained foreign capital infusions through stock sales to find the common elements of such transactions. Then a prototype can be developed to assist other companies with successful outreach efforts for foreign capital.

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[37] If the State wishes to retain some portion of the shares of certain enterprises, other methods of more closely aligning actual ownership with control over the enterprise could be explored. For example, a requirement that State-controlled shares be voted in proportion to the votes of other shareholders could be imposed. A mechanism for transferring shares to creditors in exchange for cancellation of their claims also could be developed.

[38] Currently, tenders are either "commercial" or "non-commercial." The difference is that in a commercial tender, the future investment obligations are fixed and the participants compete only with regard to the initial cash bid. In a non-commercial tender, the initial cash price is fixed and the participants compete only with regard to the future investment obligations and business plan. In both cases, the initial cash all goes to the national budget and the future investment obligations all go to the enterprise.

[39] Care must be taken, however, to craft rules in a manner that avoids creating a "moral hazard" problem where enterprises are encouraged to run up debts to the budget in advance of privatization.

Action Points:

- **Ensure that the initial share allocation in large-scale privatization is highly concentrated, with a core strategic investor receiving *at least* a majority stake. An initial concentrated ownership pattern is crucial in a country such as Ukraine with a weak legal system and poor shareholder protections;**

- **Abandon the current incremental privatization approach because it requires too much time for a strategic investor to assemble a controlling block of shares and the value of enterprises deteriorates in the meantime;**

- **Privatize to strategic investors with experience in the sector, good management records, strong reputations to maintain, and their own good corporate governance practices. Most often this will mean a foreign investor. Screen bidders carefully because an honest bidder may offer less money for an enterprise than a dishonest one. This is because the honest bidder has to do the hard work of restructuring the enterprise to make it profitable, while the dishonest bidder has a competitive advantage in that he can evade taxes, obtain favors from the Government, "cheat" when fulfilling investment obligations, engage in price-fixing, enforce contracts through force rather than the court system, not pay workers, and engage in profit skimming and asset stripping;**

- **Consider breaking large enterprises up into smaller units before privatization, perhaps through the procedures of the bankruptcy law. At a minimum, clean up balance sheets and trim labor forces to make enterprises more attractive to investors;**

- **Delete the system of "rewards and punishments" from the draft privatization program for the year 2000. Instead, privatize 100 percent of companies (rather than retaining 25 and 50 percent share packages), and rely on better screening and pre-qualification of bidders;**

- **Add to the privatization program for the year 2000 a requirement that the charters of companies going through privatization contain shareholder protections, such as cumulative voting and required shareholder approval of major transactions and interested person transactions;**

- **Use the privatization of a major State-owned enterprise as an international tender "showcase" that demonstrates a fresh market-oriented commitment by the Government of Ukraine (GOU), using stable, internationally acceptable tender procedures, valuation by an international investment bank or accounting firm to set a reasonable price floor, guaranteed sale based upon the highest cash bid, no further investment commitments or barriers to restructuring, pre-qualification of bidders, tender of a majority interest, and restricted legal grounds for challenge by unsuccessful bidders;**

- **Change the overall approach to tendering Ukrainian companies to foreign investors. Conduct privatization of State property quickly, according to simple, clear procedures. Increase the transparency of the process. Apply clear and demanding selection criteria so that the most attractive "strategically important companies" are selected for international tenders (offer the companies that do not meet the established selection criteria through less expensive and painstaking methods);**

- **After companies are selected for international tenders, grant the State Property Fund (SPF) complete ownership of the relevant assets, and prevent the branch ministries and other State authorities from interfering with the SPF's efforts to tender the enterprise;**

- **Grant the SPF discretion to remove management when the management does not complete pre-privatization restructuring and preparation for the tender in due time according to the privatization program;**

- **Commit to, and speed up the process of, *fully* privatizing large-scale strategic enterprises (70-100 percent) to develop the "critical mass" of outside, non-Government ownership necessary for improved performance;**

- **Liquidate Derzhinvest and FinProm;**

- **End the practice of transferring or selling the right to manage State shares and the resulting separation of ownership from control;**

- **Eliminate non-commercial tenders;**

- **Authorize enterprises to write off their stale debts to the Government in proportion to the money the national budget receives in the tenders; and**

- **Analyze the various Ukrainian enterprises that have successfully obtained foreign capital infusions through share sales to find the common elements of such transactions and develop a prototype to assist other companies.**

3. Bank Reform

Banks are looked to as the principal providers of capital in many parts of the world. This is particularly true where alternative sources of capital, such as corporate bond offerings or developed equity markets, are in the beginning stages of development as in Ukraine. Ukrainian banks, despite their current problems, can be a significant source of external financing for enterprises. Bank reform and effective bank regulatory practices are thus essential. A sound banking sector making impartial credit allocation decisions and loaning money to enterprises at reasonable rates is a vital element of a healthy economy. At the other extreme, without a strong banking sector mobilizing savings and extending credit to enterprises best able to use it, Ukrainian enterprises will continue to suffer crippling shortages of capital, preventing them from investing in the plant and equipment needed to produce high-quality goods to compete with imports in the domestic market and to export to the global market.

In addition, poor banking practices can potentially trigger financial market chaos and economic collapse. The economic crisis in southeast Asia demonstrated, much like the American savings and loan industry crisis did, that banking structures that are not transparent or operate on special relationships, such as ties to particular industrial sectors or to families and friends, or that operate with lax credit assessments and weak central bank monitoring practices, will harm sustainable financial markets development. Moreover, a crisis involving banks, which serve as the country's payments mechanism and thus are central to the functioning of the entire economy, have larger systemic effects than a crisis involving non-bank financial intermediaries.

Ukraine has one of the smallest banking and monetary systems in the world relative to GDP, making it hard for enterprises to borrow the money needed for payments, investments and growth. The banking system is simply not contributing significantly to the Ukrainian economy. As of October 1, 1999, there were approximately 160 banks in Ukraine with total assets (*chysti actyvy*) at just over Hr 25 billion ($5 billion).[40] The capitalization of the entire banking system in Ukraine is equal to the capitalization of one mid-size bank in California, or one large bank in Central Europe. Undercapitalization of banks in Ukraine has been a long standing problem and there are few sources of profits or new outside capital to help improve the situation.[41] Losses suffered by banks as a result of treasury bill restructuring and currency devaluations in late third quarter 1998 only worsened the situation.

The banking sector requires new approaches in order to attract additional equity capital and new sources of profit. Real interest rates must return to more sustainable levels, and smaller banks must be merged with larger ones. Encouragingly, Presidential Decree No. 44, dated January 23, 1999, "On Comprehensive Measures to Rehabilitate the Banking System in 1999-2000," laid out an ambitious and generally well-conceived plan to develop the banking sector in line with the resolutions of the Basle Committee for Banking Regulation. We urge swift completion of the items in the decree (some of which are also addressed in this Paper).

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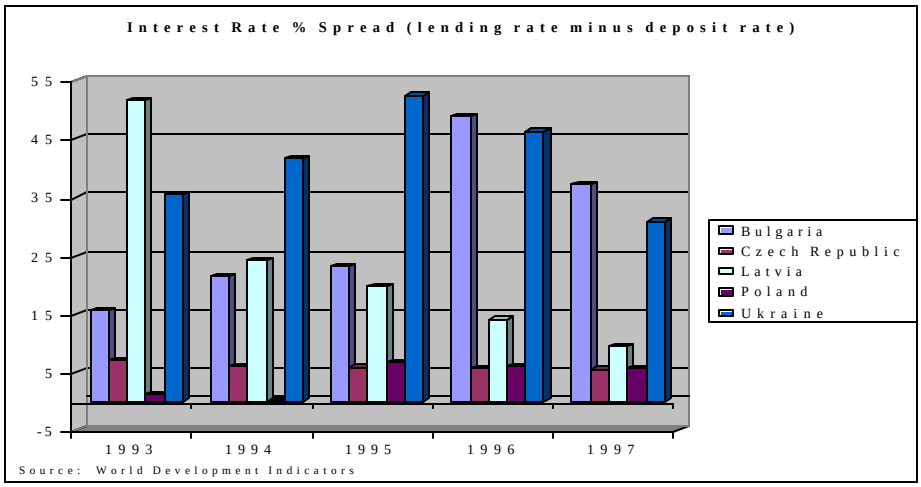
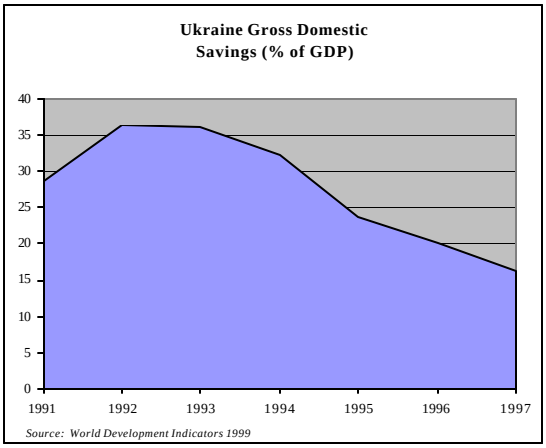
[40] As of October 1, 1999, the total financial capital (shareholders' equity) of the banking system was Hr 5.2 billion ($1.04 billion) and total regulatory capital (shareholders'equity with some adjustments) was Hr 4.6 billion ($920 million).

[41] Ukrainian Banking Association figures.



Deposits and Commercial Lending. One key problem is that banks cannot perform their functions as lenders because they are not attracting deposits. A National Bank of Ukraine (NBU) official recently was quoted in the press stating that Ukrainians are hoarding an estimated $12 billion in cash savings at home. Legal entities also avoid banks to the extent possible. In fact, they focus their energies on finding ways to get money out of the banking system and into cash. Enterprises are forced to keep some money in banks in order to do business, but because of safety and soundness concerns and the fact that the State Tax Administration (STA) receives information about money in bank accounts and has the power to seize funds for payment of tax arrears (the "kartoteka 2" system), enterprises keep substantial cash outside of the banking system.[42] It has been estimated that approximately 50 percent of the entire money supply is circulating outside of the banking system.[43] Capital flight is also a serious problem. An estimated $20-25 billion has been illegally exported from Ukraine during the last seven years. These problems are debilitating to the economy.



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[42] Kartoteka No. 2, the "card-index" listing an enterprise's debts to the Government, has long been considered a socialist anachronism. The "Kartoteka system" allows the Government to take money out of private bank accounts without due process or effective right of appeal. It destroys confidence in the banking system, distorts the proper functioning of the system of priorities among creditors, and drives enterprises into the shadow economy. Moreover, even before enterprises were recently granted the right to have accounts in different banks, they had learned to work around the Kartoteka system by structuring transactions as mostly barter deals plus a small amount of cash. Today the Kartoteka system has been rendered largely ineffective as a tax collection device. It should be replaced with normal court-based lien and bankruptcy procedures. There have been numerous attempts to end this practice – the last in a June 28, 1999 Presidential Decree and accompanying draft law – all of which have failed.

[43] World Bank figures, 1998.

And, just as enterprises do not trust banks, banks do not trust enterprises. Thus, banks are reluctant to make commercial loans, or demand an unreasonable interest rate to do so, for fear that enterprises will default. The lack of credits is particularly acute for new businesses that do not yet have sufficient internally generated capital (Box 3.2). Bankers complain that few companies use international accounting standards or create cash flow projections, and that the success of companies is linked to extraordinary circumstances that bankers have no way of knowing. Thus, the risks associated with lending to a particular enterprise are too complicated to assess. Instead, banks invest in Government debt which does not contribute to growing the real economy.[44] This is a complex problem not easily solved, but one recent step should improve the situation – the new requirement that enterprises follow National Accounting Standards (NAS), drafted in accordance with international standards, starting in 2000. As accountants become conversant with the new standards, banks will have more reliable information upon which to base lending decisions.

Bank Regulatory Environment. To ensure that banks play their essential role in financial markets development – as lenders, or credit allocators, and performance monitors – the central bank regulatory authority must implement effective prudential regulation to ensure the safety and soundness of the financial system.[45] The fact that bank depositors themselves are not in a position to monitor a bank's finances calls for strong Government action to fulfill this role. Moreover, the Government must also ensure that there are strong prudential regulation and supervision systems *within* the banks, particularly risk management systems. The NBU is to be commended for having made substantial progress in this regard – although its performance in the regions is less impressive – but more can be done so that the banking system in Ukraine can begin to play an effective role in the allocation of capital and the development of the economy.

1. Licensing: It is crucial that bank regulators protect depositors by establishing fundamental requirements for entry into the banking business. The NBU has made a good start by tightening its licensing requirements in recent years. The current banking law, however, does not allow the NBU to perform this function fully because it does not include any requirement that managers and large shareholders of banks be of high integrity ("fit and proper"),[46] and does not contain "fiduciary duty"[47] standards for managers and directors.

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[44] Recent problems in the treasury bill market may have actually resulted in more funds being available for commercial lending. This is somewhat offset, however, by the currency devaluation and the increase in monetary reserve and Euro-denominated bank capital requirements. See footnote 112. Perhaps the demise of the treasury bill markets has had the greater effect – interest rates on commercial bank loans have dropped approximately 20 percent since September 1998 (although they are still extremely high relative to inflation in the economy).

[45] It is important to remember that Ukrainian banks are still relatively new at performing the functions of a bank in a market economy, rather than simply allocating credit as directed by the Government, which was their function under central planning. Under a market economy, banks must learn to screen and monitor borrowers, selecting projects and making decisions about which firms have the best prospects for successful expansion and thus loan repayment.

[46] Whether a person is "fit and proper" should be based on objective facts from which a determination can be made about his managerial skill, legal and regulatory compliance, and integrity. Such facts should include prior experience in bank management and operations, education level, absence of criminal convictions or other legal sanctions, not having managed a company that went

To supplement its analysis when making a licensing determination, the NBU might consider instituting a system of objective, written tests for managers and directors, testing them on basic market economy banking principles. Anyone unable to pass such a test would be ineligible to occupy the position. Objective tests would ensure that relationships – or the simple fact of already occupying a position – would not be determinative in the NBU's decisions.

2. Monitoring: Bank regulators must ensure that licensed banks continue to comply with relevant law and rules through mandatory periodic reporting, reviews of those reports, and on-site examinations. While the NBU has made strides in this area as well, we believe that the NBU needs to shift its focus toward issues that relate more closely to bank supervision and depositor protection. Currently it appears that the focus too often is on purely procedural violations. Monitoring is time consuming and expensive and thus needs to be focused on the most important aspects of a bank's operations.

There are also problems with legislation in this area. Neither current law nor the NBU's regulatory provisions against insider lending are as strong as they need to be. First, current provisions focus primarily on the ratio of credits to insiders in relation to a bank's capital. While this is one necessary component, it is not sufficient. It is also important to require that any loans to insiders be on market (not preferential) terms.[48] In addition, banks are authorized to engage in a number of activities other than lending (such as securities and investment activities), and, in these areas as well, provisions need to be enacted prohibiting preferential treatment for bank insiders. Finally, the new Law "On the National Bank of Ukraine" contains a definition of "insider" or "related person," but the provision focuses on the access of a person to the confidential information of a bank. As a practical matter, this is not what makes a person (whether physical or legal) an "insider" or a "related person" of a bank; rather, it is the ability to exert significant influence on the bank's management or policies, or being affiliated with, or controlled by, persons who control or manage the bank. Thus, this norm of the law needs to be amended.

3. Sanctioning: Laws and regulations are ineffective if bank regulators do not impose sanctions for their violation. In Ukraine, however, the problem is not a lack of sanctions – the NBU imposes perhaps too many fines – the problem is that sanctions appear to be imposed arbitrarily and not in proportion to the violation. Sanctions also are often imposed for technical violations that have little relation to

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bankrupt, and so on. The analysis should also include additional facts that reflect on the person's managerial capability, soundness of judgment, and history of fair dealing. If a large shareholder of a bank is a legal entity, the "fit and proper" analysis is applied to the person(s) that control that legal entity. It is important to establish a legal foundation for a thorough but fair determination by the bank supervisor of the suitability of prospective bank owners and managers (who, after all, are authorized to handle enormous quantities of other people's money).

[47] A "fiduciary" is a legal or natural person holding assets on behalf of another person (a beneficiary). The fiduciary is legally charged with a "fiduciary duty" to prudently handle the assets, and may be charged with a duty to invest the assets, in which case investments must be prudent and only for the benefit of the beneficiary.

[48] Normative 11 of the NBU "Instructions for Regulation and Analysis of the Activity of Commercial Banks" does require that loans to insiders be on market terms. This rule is apparently not effective, however, because the requirement is often ignored in practice.

bank supervision or depositor protection.[49] We thus recommend that the NBU focus on ensuring that fines are imposed in an objective, readily understood and prioritized fashion.

There are also problems with legislation related to sanctions. Previously, the (now-repealed) Article 48 of the Law on Banks and Banking did not grant the NBU power to issue compulsory corrective ("cease and desist") orders requiring that violations be corrected or a bank's operations improved in a manner satisfactory to the NBU. Where there was a problem, the NBU could only impose severe measures. This limitation has been solved by Article 62 of the newly-enacted law "On the National Bank of Ukraine." Unfortunately, the new law solved this problem but created another. The NBU now must first issue a "cease and desist" order in every case. Only if the violations are not eliminated within the required time period can the NBU impose more severe measures, such as fines on the bank or its managers, or removing the chairman of the board or chief accountant (but not other managers) and appointing a provisional administrator.[50] If the financial condition of a bank is rapidly-deteriorating, however, or if a bank manager has proven to be fundamentally untrustworthy or incompetent, the immediate imposition of stern measures is often crucial. The NBU must be authorized to decide when to issue a "cease and desist" order and when it is necessary to go directly to more severe remedies.

Another limitation of the legislation in this area is that the NBU does not have the authority to require reimbursement of losses from grossly negligent or dishonest bank owners or managers who have caused a bank to fail.

Path to Reform. The NBU should continue and intensify its efforts to strengthen its bank supervision, internally and throughout the nation's banking system. Reform efforts should include the following:

1. Bank Closures: Serious bank reform will require the NBU to more strictly enforce its capital and other requirements, which undoubtedly will mean closing or reorganizing banks. Banks that cannot meet the requirements of the NBU, and that cannot present a convincing plan for meeting the requirements within a reasonable period of time, must be closed or reorganized *now* rather than waiting for serious problems later.[51] The NBU must not allow a bank to continue to function when it is insolvent – the systemic risk is too great. This is a difficult and politically unpopular course that causes short-term disruptions, but it begins long-term strengthening of the safety and soundness of the banking system.

A critical issue is the authority of the NBU to appoint a liquidator for a bank.[52] Article 62 of the law "On the National Bank of Ukraine" allows the appointment of a

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[49] This tendency to focus on procedural, technical violations rather than those violations that most harm depositors (or investors) is not limited to the NBU. As we describe in Chapter Four, the Securities and Stock Market State Commission (SSMSC) also exhibits this tendency, and we suspect that it may be endemic to all Government regulatory agencies in Ukraine.

[50] The authority of a provisional administrator and the effect of his appointment on the rights of a bank's shareholders and managers is unspecified in the law.

[51] The NBU recently deprived several banks of all of their licenses except to perform account and cash services, and withdrew certain specific licenses from a larger group of banks, due to the banks' failure to meet capitalization requirements.

[52] Currently there is a lack of clarity regarding the legal process for liquidation of Ukrainian banks. Although the NBU has the authority to liquidate banks itself, banks are also subject to the general

liquidator when a bank is insolvent, which is defined as: 1) the bank is unable during one month to meet the claims of creditors (i.e., depositors); or 2) the regulatory capital is less than one third of the minimum required amount. While the second component is acceptable, the first will create problems. Fast action is absolutely critical when depositors' funds might be in jeopardy. If a bank cannot meet the withdrawal requests of its depositors, the NBU should not be required to wait a month before appointing a liquidator. During that time, the problem could grow. News that a depositor cannot gain access to his funds spreads rapidly. The result is likely to be a general depositor panic (a "run" on the bank) that could spread to other banks, prompting a systemic liquidity problem. Also, if the bank's owners or managers are untrustworthy, they will take the opportunity to abscond with whatever is left of the bank's assets during the month period after the liquidity problem becomes known but before the NBU is entitled to act. When a depositor cannot gain access to his funds, the NBU should be authorized to take control of the bank immediately.

2. Capital Requirements: The NBU has gone a long way toward implementing capital requirements that meet international standards.[53] Minimum capital requirements, however, are not sufficient. In addition, the capital adequacy of a bank must be examined individually based on the overall risk inherent in the bank's operations. Moreover, even the general capital requirements are currently ineffective because assets are often overstated. Encouragingly, the NBU has begun to adopt policies on asset evaluation in order to correct the situation.[54] If the NBU were to vigorously enforce its existing capital requirements based on proper asset valuations, and to examine the adequacy of each bank's capital in relation to its risk exposure, this would undoubtedly require a significant number of banks to be closed or reorganized.

3. Minimum Functions of a "Bank": There are some "banks" that do not have a license to accept deposits from natural persons or, in some cases, to accept deposits at all (there are approximately 30 different separately licensed banking activities). Institutions that are not licensed to accept any deposits, either individual or corporate, should be closed or called something other than "banks." Consideration

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bankruptcy law. Thus, as a practical matter, some liquidations are undertaken by the NBU, and some through an arbitration court proceeding. Which procedure is used depends mostly on who – the bank's creditors or the NBU – initiates the process first. We believe that the law should be clear that the NBU has the sole authority to conduct the liquidations of banks in order to facilitate the process of depositor protection and maintenance of the stability of the banking system. Importantly, creditors with outstanding claims must be able to force the NBU to act (just as creditors of an industrial enterprise with outstanding claims can "force" a bankruptcy court to act). Unfortunately, the new law "On the Restoration of Solvency of the Debtor or Declaring it Bankrupt," adopted June 30, 1999, does not improve or clarify the situation. It states only that bankruptcy proceedings against banks shall be subject to thespecial features of the law "On Banks and Banking Activity" (Art. 5.2).

[53] The most important benchmark for bank safety and soundness is not statutory capital but rather the ratio of capital to assets. Such ratios indicate the margin of safety of a bank– i.e., they are based on the amount by which assets exceed liabilities.

[54] One potential problem is that the NBU is relying on Basle standards for the risk rating of different asset classes, even though they were developed for Western countries with more developed financial systems. To take one example of a mismatch in financial environments, treasury bills are considered "risk free" in Western financial regulations. Clearly they are not "risk free" in Ukraine. Thus, the Basle standards are based on levels of default and impairment risk that are overly optimistic for Ukraine. The Basle standards are the right starting point, but they should be modified to fit the situation here. (Politically, however, it may be unacceptable to assign other than a zero risk-weight to treasury bills).

should be given to restructuring smaller banks that are struggling to operate under full bank status so that they would operate as "credit unions" that offer low-end services (Box 3.1).

4. Directed Credits: The former practice of State officials directing bank credits has been sharply reduced but continues even today.[55] Inevitably, such loans are not fair and reasonable by arm's length commercial lending standards, and should not be permitted.

5. Legislation: Many of the problems discussed so far can only be solved by law. Extensive work has already been done on a revised, comprehensive law "On Banks and Banking Activity" that addresses these problems and that incorporates the Basle Core Principles. This law should be passed as soon as possible.

Other Specific Reforms. Other recommended practices that have served banking systems well elsewhere, and that contribute to the stability of banking systems generally, include the following:[56]

1. Forced shared risk: One objective of a bank regulatory scheme is to promote prudent actions by banks. Regulations should recognize two points: 1) monitoring bank practices is costly and imperfect (banks can hide or distort and create a "book" value vastly beyond "true" value); and, 2) the more value or net worth a bank is required to have, the more care those in control of the bank will take to preserve its value. Thus, regulations that impose the consequences of losses on the owners of the bank are strongest. Controlling shareholders should be given an incentive to share the burden of bank supervision – i.e., they should know that they could lose their investment if they do not watch over the managers. In this regard, it is currently too easy for shareholders to withdraw capital when a bank is in trouble by way of share repurchases or dividends. The revised law "On Banks and Banking Activity" contains norms that would correct this problem.

2. Lender of last resort: In times of perceived crisis, the ability of the central bank to lend to banks, and its willingness to do so, can stop a bank run and deter a full crisis. Serving as a lender of last resort can prevent such short-term liquidity problems. According to Article 7, Item 3 of the Law of Ukraine "On the National Bank of Ukraine," the NBU has such power to act as a "lender of last resort" for commercial banks. Encouragingly, the NBU acted quickly to fulfill this function

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[55] Certain banks extend loans at the request of the State not because their "arms are twisted," but because they want to continue servicing budget accounts such as those of the Pension Fund, post-office and customs service. The State's relations with these banks, however, should be "normalized" so that the State is treated like any other large customer of the bank.

[56] One reform that we do not recommend at the present time is expanded deposit insurance. Presidential Decree No. 996/98, dated September 10, 1998, initiated a limited deposit insurance system in Ukraine for natural persons with a ceiling of 500 Hrivna ($100) per person. The NBU has estimated that the average personal deposit (excluding the Savings Bank) equals Hr 533 ($107). As of December 1, 1999, the deposit insurance fund totaled approximately Hr 48.8 million ($9.76 million). We believe that even this limited measure may have been premature. Any deposit insurance scheme should be implemented cautiously and only after improvement of the health of the banking system and improvement of bank supervision in the regions. The GOU has only one opportunity to make deposit insurance work because citizens will never trust the system again if it fails to compensate losses even one time. The risk that the system will be unable to meet demands is simply too great given the poor health of the banking system.

during the potential systemic liquidity crisis in September 1998 precipitated by the Russian default.

3. Credit information sharing: The banking system should share information on credit risks; this will result in a collectively stronger system as a whole. A "Bureau" owned by the banks or existing as a unit of the NBU could be established as a repository of loan and contingent liability profiles, including the debt performance history of borrowers and information about the collateral provided to secure loans. While confidentiality issues are important, such credit information sharing is in the interest of all lenders and of bank supervision. The mere existence of such information sharing will deter creditor fraud and encourage debt service performance.[57]

4. Innovative methods to encourage long term lending: The Government might consider exempting from taxation bank profits on long term (five years or longer) commercial loans. Such long term lending is exactly what enterprises need to engage in real restructuring and modernization. Moreover, little tax revenue would be lost as such lending is likely to represent a small part of banks' profits.

5. Methods to attract "shadow" capital into the system: Efforts to attack the shadow economy through imposing rules on the banking sector are not working. Companies have learned how to get around such rules, including how to operate effectively outside of the banking system. Capital circulating outside of the banking system must be brought back into the system. Therefore, we believe that policymakers should end the requirement that banks turn over data on their clients to tax inspectors. Policymakers should reconsider proposals to end the "Kartoteka 2 system" and replace it with more market-oriented tax collection methods. Further, recent NBU prohibitions on transactions between Ukrainian banks and offshore banks, and prohibitions on offshore companies and their subsidiaries holding shares in Ukrainian banks, should be considered carefully. The NBU is right to be concerned about the legality of capital, but must also focus on attracting flight capital back into the country.

6. Improved property registries and collateral rules: Reliable centralized registries for information on secured assets are crucial to stimulate lending to enterprises. Accordingly, recent amendments to the law "On Pledge" that led to the creation of a movable property pledge registry in Ukraine, which for the first time provides notice of commercial pledges and tax liens, are to be commended.[58] However, the registry is of limited commercial value so long as it only warns of formal pledges and tax liens, and does not also provide notice of other types of secured transactions.[59] Current law provides for at least five methods of creating a security

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[57] The registry that the Agency for Bankruptcy Issues is required to create and maintain pursuant to the new bankruptcy law should play an important role by providing creditors with information about bankruptcy filings.

[58] The movable property pledge registry became operational on March 1, 1999, and as of November 30, 1999 had more than 40,000 entries.

[59] Suppose that a manufacturer asks a bank for a loan, secured by a pledge of the manufacturer's equipment. When the bank searches the registry for prior interests in the borrower's equipment, only previous pledges will be revealed. The manufacturer's equipment, however, may have been leased, or the seller may have retained title (with transfer of title to the buyer conditional on the buyer paying the purchase price).

interest in property.[60] It should make no difference whether collateral is subject to a pledge agreement, or some other form of security agreement. Lawmakers must abandon reliance upon traditional forms of transactions that do not reflect the needs of modern commerce. Thus, a single property right to obtain credit and create a security interest using different methods, based on movable property or property rights of any kind (e.g., intellectual property, securities, accounts receivable, etc.), is needed. The movable property pledge registry must be expanded to include these other types of security interests. Further, it must be simple and inexpensive for the debtor to convey a security interest to the creditor.

In addition, appropriate and clear collateral evaluation and priority rules are necessary. Ukraine now relies on a rigid "first-in-time, first-in-right" priority rule that inhibits commerce in several ways:

- Enterprises are cut off from the capital necessary to grow because creditors won't lend, or will only lend at exorbitant interest rates, when another creditor has a prior security interest in the debtor's assets;
- Banks and other lenders are deprived of opportunities to make safe, secure loans; and
- Bankruptcy trustees are deprived of a necessary tool in restructuring insolvent enterprises.

The rigid "first-in-time, first-in right" priority rule should be replaced with a comprehensive priority scheme that includes, for example, purchase money security interests.[61] Moreover, a registry and good priority rules mean nothing without effective collateral repossession and realization procedures. Work is needed to improve these procedures so that, upon default by the debtor, a creditor can quickly and at low cost take possession of and sell property in which it has a security interest.

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[60] A security interest is a form of interest in property which provides that, upon default, the property may be used to satisfy the obligation for which the security interest was given. The ability of a borrower to convey a security interest in property to a creditor stimulates the flow of capital in an economy by reducing the risk of non-repayment on a debt obligation. By way of example, a security interest can be created through a formal pledge agreement; by a creditor taking and maintaining possession of collateral; by the seller of property retaining title to the property, etc.

[61] A "purchase money security interest" is a security interest in property granted by the buyer of the property to the seller in lieu of cash. Thus, the property is used as collateral for a "loan" by the seller to the buyer. A purchase money security interest makes it possible to sell property to a buyer who has insufficient funds and/or no access to commercial loans. For example, a farmer who has granted a bank a general lien on all his property should be able to grant a "purchase money security interest" in a new tractor to the tractor's seller that has a higher priority with respect to the tractor than the bank's general lien. This rule would not increase the bank's risk because the bank still has all the collateral it had when it made the loan, as well as a junior position on the new collateral. The rule would bring a number of overall benefits to the economy. Borrowers would have access to the funds necessary to grow and increase their productivity and profitability, and lenders would have new avenues for secured lending to productive enterprises.

[62] Pursuant to a Presidential Decree, dated December 15, 1999 – one of a package of three decrees instituting administrative reforms – the State Agency for Bankruptcy Affairs was liquidated and its functions transferred to a to-be-created "State self-supporting body" that will be subordinated to the Ministry of Economy.

Box 3.1

Other Non-Bank Financial Institutions

In addition to the securities markets institutions and commercial banks discussed throughout this Paper, there are other non-bank financial institutions whose development should be encouraged by policymakers. Various creative methods and business models are needed to stimulate the flow of capital in the economy to facilitate economic growth.

Factoring companies purchase accounts receivable (invoices) from enterprises. This allows an enterprise to receive capital immediately, without having to wait to receive payment on its debts. The enterprise, of course, must accept a discount from the face value of the debts in return for this service. After receiving the debt, the factoring company acts as a principal, not an agent – i.e., the factoring company takes title to the debt. The receivables are sold without recourse, meaning that the factoring company cannot turn to the seller if the receivables prove uncollectible. The factoring company is essentially acting as a collection agency, assuming responsibility for collecting the accounts receivable, and thereby realizing a profit.

Leasing companies rent productive assets, such as bulldozers, tractors, and cement mixers, or service equipment, such as computers or copy machines, to businesses which otherwise would not be able to meet the required capital outlays or borrowing costs to obtain such equipment. Leasing companies profit from the stream of lease payments and, frequently, from tax benefits arising from depreciation of the assets.

Insurance companies offer risk protection in the form of guaranteed payments upon occurrence of certain specified events, in return for a stream of payments (policy premiums) from customers (policyholders). Premiums are determined by the company's projections of claims, expenses, and profit margins. To reduce the risk that policyholders will dispose of property intentionally just to receive the insurance proceeds, or, for example, visit the doctor more than is necessary, insurance companies often reimburse expenses only above some minimum (deductible) amount. Life insurance companies offer policyholders guaranteed payments in the event of loss of earnings due to death, disability, or retirement. Property-casualty insurance companies offer protection against the risks of fire, theft, adverse weather, or negligence resulting in harm to property or person.

Credit unions are non-profit deposit and credit institutions for owner-members. They are essentially co-operatives in which the members lend money to themselves. Credit unions offer low-end services to individuals and small businesses, and maintain a smaller spread between loan and deposit interest rates than do commercial banks.*

Investment banks (merchant banks) specialize in underwriting: selling new issues of clients' shares to the public. As underwriters, investment banks serve as intermediaries between issuers of securities and the investing public, either as agent for the issuer or as a principal (in which case the investment bank itself buys the shares and then resells them to the public).** Investment banks also advise clients on mergers and acquisitions, portfolio management, and foreign exchange operations. Finally, investment banks sometimes participate themselves in commercial ventures, buying blocks of shares and managing businesses, hoping to sell them later at a profit.

Venture capital (risk capital) companies specialize in providing financing for start-up companies that entails high investment risk but the potential for above-average future profits. Venture capital supplements other personal or external funds to which an entrepreneur has access. In come cases, a venture capital company may be willing to provide financing to an entrepreneur when a commercial bank would consider the risk too great.

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* The co-operative structure of credit unions might give Ukrainians the confidence they need to once again entrust their money with an institution.

** In Ukraine, underwriting is one of the listed activities that may be performed pursuant to a "securities trader" license.

These issues require a comprehensive approach. Accordingly, a draft law "On Securing Performance of Obligations with Movable Property" has been developed that addresses all of these issues. The draft law was recently submitted to the Verkhovna Rada – every effort should be made to finalize and pass this law as soon as possible.

In addition, uncertainly of land ownership and lack of a reliable registry of title to land present a barrier to private mortgage lending. Land titling and a comprehensive land title registry are necessary so that land can be used as collateral for loans. Once creditors can rely with *confidence* on land as collateral, this should significantly increase lending in the economy.

7. Bankruptcy: Sound and predictable bankruptcy rules are also needed to ensure banks and other creditors that their claims will be handled fairly in the event of insolvency of the borrower. Recent passage of the Law of Ukraine "On the Restoration of Solvency of the Debtor or Declaring it Bankrupt" was an important step forward. The new law expresses a clear preference for reorganization over liquidation, providing a variety of powerful tools to restructure and reorganize a debtor enterprise.

In order to ensure that the new bankruptcy law works as intended, there are several vital elements that must be in place.

A. A major initiative is needed to train judges, lawyers, trustees, creditors and debtors to understand and use the new law. Importantly, the law charges the State Agency for Bankruptcy Affairs with setting up a training system for trustees (Art. 2.2).[62]

B. The law states that a court shall commence bankruptcy proceedings if the total amount of *"indisputable claims"* of a creditor(s) against the debtor is at least 300 statutory minimum monthly wages. It is crucial that arbitration courts not interpret this to mean that creditors must obtain a court ruling that a claim is valid *before* filing a bankruptcy petition, as was the practice previously. The validity of claims should be established at the initial bankruptcy hearing; requiring a separate pre-petition court ruling would impose a significant, unnecessary burden on creditors.

C. If bankruptcy is to result in effective reorganization of the debtor, it will often require that the shares of a company be canceled and new shares issued, without the consent of the shareholders. It may require that creditors receive shares in exchange for their claims (such "debt for equity swaps" are allowed by Art. 37.4). The Securities and Stock Market State Commission (SSMSC) must work to ensure that securities legislation and SSMSC procedures allow these bankruptcy provisions to work smoothly. Similarly, the proposed new law "On Joint Stock Companies" should define conditions pursuant to which the bankruptcy trustee may cancel or dilute the outstanding shares and issue new ones.[63]

D. The bankruptcy law does not have an explicit test for when a court can liquidate a company. The test generally should be that a court may order a company's liquidation when creditors will receive more in liquidation than in a

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[63] One way to balance shareholders' ownership interests with the rights of creditors is to authorize a restructuring of the debtor's capital so that the old owners' interests reflect the extent to which the liquidation value of the debtor in bankruptcy exceeds the total debt. If the debt exceeds the liquidation value of the assets, then the owners have no interests to protect.

reorganization. We recommend that the Highest Arbitration Court issue an "Explanation" specifying that this is the test courts should use.

E. Consideration should be given to advancing the deadline for application of the law to agricultural production enterprises. The law exempts such enterprises from its provisions until January 1, 2004. Exempting this sector appears to have been based on the fear that there would be wholesale liquidations of such enterprises. In fact, however, the exemption may have the unintentional result of actually increasing the number of defunct, non-operational enterprises in the agriculture sector, which sector probably stands to benefit as much or more than any other from the law's powerful tools for restructuring.

F. Ukraine should work towards early adoption of the United Nations Commission on International Trade Law (UNCITRAL) "Model Law on Cross-Border Insolvency". The Model Law is designed to assist countries to equip their insolvency laws with a modern, harmonized and fair framework to address instances of insolvency of companies with assets in more than one country, or where some of the creditors of the debtor are not from the country where the bankruptcy proceeding is being held. The Model Law is not designed to replace a country's bankruptcy law, but to supplement it with provisions to resolve specific problems arising in cross-border insolvency cases. This is important to foreign investors.

Box 3.2

Small and Medium-Size Business

Parts of this Paper, particularly the chapters on privatization and the securities markets, are focused on large enterprises. This follows from the fact that Ukraine has many such enterprises dating back to the Soviet period. But policymakers should keep in mind that small and medium-size businesses (SMBs) – firms with fewer than five hundred workers – are the main engine for job creation in economies around the world. SMBs are generally more flexible than large enterprises and thus can quickly adapt to rapidly changing market conditions and seek out opportunities, creating new jobs in the process.

Any plan for financial markets development must ensure that SMBs have access to sources of capital beyond family and friends that they can draw upon to grow and create jobs. Such sources should include: i) commercial bank loans, with a system that allows lenders to perfect and execute on security interests in real estate, moveable property, or property rights of any kind;[1] ii) loans secured by purchase money security interests; iii) credit financing guaranteed by long-term contracts for supply of products or services; iv) debt and equity venture capital; v) factoring; and vi) leasing. In addition, the Government must create a favorable regulatory climate to encourage SMB development. SMBs, with limited staff, are hit particularly hard by extensive regulatory requirements that force them to divert resources away from running and growing the business. Clearly, Ukraine has a long way to go: in the West, SMBs account for 40 to 60 percent of GDP, while in Ukraine they account for only about 8 percent.

The State must change its attitude towards business. An October 1999 SMB Congress in Kyiv, as well as various surveys, have highlighted the problems entrepreneurs face in Ukraine. High tax rates and numerous taxes, corruption, excessive regulatory burdens, and frequently changing legislation are all cited as problems that hinder the development of business, with taxation topping the list. [2]

Although numerous problems continue to plague SMBs, some positive trends are now evident. The number of inspections undergone by the average small business fell to thirteen in 1998.[3] Interestingly, this drop in inspections cannot be explained by the Presidential Decree "On Certain Measures to Deregulate Entrepreneurial Activity" which was enacted in the latter part of that year.[4] Possible alternative explanations for the decline in inspections include a shift by inspection agencies to larger enterprises – which in fact reported an increase in inspections in 1998 – or perhaps a reaction to the high profile attention drawn to the plight of small businesses.

The amount of time required to complete the various regulatory steps necessary when starting a new business dropped dramatically between 1997 and 1998, from thirty days to fourteen.[5] The maximum time for issuance of the State registration certificate itself is now limited by legislation to five working days. And the time required to obtain a license to undertake a specific type of business activity – required by almost half of new businesses surveyed – decreased substantially in 1998.[6] We understand, however, that reforms are uneven, with some regions slow to implement changes.

Another positive development is that the law "On Entrepreneurship" was amended, limiting the number of licensed business activities to forty-three.[7] Further, as discussed in Chapter Nine, a flat tax was recently introduced for SMBs, and, beginning January 1, 2000, off-budget funding will be eliminated for almost all Government agencies. Finally, numerous small business development programs and consulting centers have been established at both the regional and national levels.[8]

These are encouraging trends, but more is needed. Policymakers should drastically reduce even further the regulatory burdens on SMBs, while implementing policies that will ensure that they have access to debt and equity financing. In particular, current trends in the banking sector must be reversed so that SMBs have access to credits. Policymakers could consider implementing incentives to stimulate commercial lending to SMBs. Only with further reforms will SMBs begin to play the vital job creation role they play in other countries.

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[1] Access to credit has decreased as a result of the liquidity crisis that hit Ukraine in the wake of the Russian financial crisis. In 1997, only 16 percent of SMBs surveyed complained of a lack of credit, compared with 52 percent in 1998.

[2] Much of the evidence in this discussion is taken from "The State of Small Business in Ukraine," International Finance Corporation (IFC), May 1999.

[3] Only 8 percent of SMBs surveyed, however, did not undergo at least one inspection – averaging five days – by the tax administration and tax police in 1998. In 1997, when any monitoring body could inspect any enterprise at any time for almost any reason, the average SMB underwent some 78 inspections per year.

[4] Presidential Decree dated July 23, 1998 "On Certain Measures to Deregulate Entrepreneurial Activity" limited the number of financial inspections that may be conducted in one year by various State bodies.

[5] In part, this decrease in time required was the result of Cabinet of Ministers (COM) Resolution No. 740, May 1998, "On Procedures for State Registration of Subjects of Entrepreneurial Activity," which requires local authorities, rather that entrepreneurs themselves, to submit the required documents to various State agencies.

[6] The decrease in the time required to obtain a license was largely the result of COM Resolution No. 1020, July 1998, amending the procedures for licensing business activity.

[7] Forty-three is not the actual number in practice, however, as there continue to be a large number of other required permits and license-like requirements created by various State bodies.

[8] Unfortunately, few businesses report that they have sought assistance from these business development programs and consulting centers, and 88 percent of SMBs surveyed do not have even a business plan.

Action Points:

- **Explore new approaches to attract additional equity capital and new sources of profit into the banking sector. Work to return real interest rates to more sustainable levels, and encourage the merger of smaller banks with larger banks;**

- **Take dramatic steps to reduce the informal (shadow) economy, expand the formal economy, and stem capital flight in order to bring money into the banking system so that it is available for commercial lending;**

- **Drastically reduce the regulatory burdens on small and medium-size businesses (SMBs), while implementing policies to ensure that they have access to debt and equity financing. Consider implementing incentives to stimulate commercial lending to SMBs;**

- **Amend the law "On Banks and Banking Activity" to add a requirement that managers and large shareholders of banks be of high integrity ("fit and proper"), and to add "fiduciary duty" standards for managers and directors;**

- **Encourage the National Bank of Ukraine (NBU) to consider instituting a system of objective, written tests for managers and directors, testing them on basic market economy banking principles, to supplement its analysis when making a licensing determination;**

- **Shift the focus of the NBU's monitoring of banks toward violations that relate more closely to bank supervision and depositor protection rather than purely procedural violations;**

- **Strengthen provisions against providing preferential treatment to bank insiders, and extend these provisions to other bank activities such as securities and investment activities. Expressly write such standards into the revised law "On Banks and Banking Activity";**

- **Amend the definition of "insider" in the banking legislation to include entities under the control of bank managers and major shareholders and entities with the ability to significantly influence a bank, rather than focusing on access to confidential information in defining "insider" status;**

- **Encourage the NBU to impose fines more closely in proportion to the seriousness of violations;**

- **Amend the banking legislation to give the NBU the option of imposing corrective ("cease and desist") orders, or immediately taking more severe measures, depending on the seriousness of the problem;**

- **Give the NBU the authority to require reimbursement of losses from grossly negligent or dishonest bank owners or managers who have caused a bank to fail;**

- **Amend the banking and/or bankruptcy legislation to make it clear that the NBU has the sole authority to conduct the liquidations of banks.**

Ensure that creditors with outstanding claims are able to force the NBU to act;

- **Revise the definition of "insolvency" in the law "On the National Bank of Ukraine" to give the NBU the authority to appoint a provisional administrator or liquidator whenever a depositor cannot gain access to his money;**

- **Vigorously enforce the NBU's existing capital requirements based on improved asset valuations, and examine the adequacy of each bank's capital in relation to its risk exposure. Consider whether the Basle standards for risk rating of different asset classes need to be adjusted to reflect the levels of default and impairment risk in Ukraine. Aggressively close or reorganize those banks that do not meet the requirements and cannot present a convincing plan for meeting the requirements within a reasonable time period;**

- **Close institutions not licensed to accept any deposits, either individual or corporate, or rename them something other than "banks." Consider restructuring smaller banks that are struggling to operate under full bank status into "credit unions";**

- **Encourage the development of non-bank financial institutions such as factoring companies, leasing companies, insurance companies, investment banks (merchant banks), and venture capital (risk capital) companies;**

- **Promptly pass the revised law "On Banks and Banking Activity" (If this draft were to be passed in its present form, this would accomplish several of the other action points listed here);**

- **Impose restrictions on shareholders' ability to withdraw capital, by way of share repurchases or dividends, when a bank is in trouble;**

- **Encourage the creation of a "bureau" to share loan and contingent liability information between banks, including the debt performance history of borrowers and information about the collateral provided to secure loans;**

- **Consider exempting from taxation bank profits on long term (five years or longer) commercial loans;**

- **Replace the "Kartoteka No. 2" system with normal court-based lien and bankruptcy procedures;**

- **Finalize and pass the draft law "On Securing Performance of Obligations with Movable Property" in order to provide a comprehensive scheme for secured lending that reflects the needs of modern commerce;**

- **Remove the uncertainty surrounding land ownership, and develop a dependable registry of title to land, so that land can readily be used as collateral for loans; and**

- **Ensure that the new bankruptcy law works effectively in practice so that debtor enterprises are restructured and reorganized.**

4. Securities Markets' Role in Financial Markets Development

Organized securities markets provide a regulated forum for companies to solicit and secure financing and to trade previously issued securities. Simply put, organized securities markets – i.e., stock exchanges and electronic stock markets (trade organizers) together with registrars, custodians, and depository, clearance and settlement facilities (post-trade infrastructure) – provide a forum where buyers and sellers can agree upon and then conclude securities transactions. Securities markets can contribute significantly to a vibrant economy by reducing the time and cost that issuers, buyers, sellers, and their agents would otherwise spend on finding and dealing with transactional counterparties (Box 4.1).

Box 4.1

Why are Organized Securities Markets Important?

If commercial bank loans and strategic direct investment – neither of which requires organized securities markets – are the most important sources of capital, know-how and "outside monitoring" for enterprises, why are securities traders, stock exchanges, trading and information systems, registrars, depositories, clearance and settlement facilities, investment funds, investment banks, and the Securities and Stock Market State Commission (SSMSC) important? That is, why are organized securities markets important for the growth of the Ukrainian economy? In fact, there are multiple reasons.

First, securities markets provide a place for Ukrainian citizens to invest their savings. Right now, Ukrainian citizens keep their savings in hard currency "under the mattress." If liquid, safe and transparent securities markets can be developed in Ukraine, citizens will be able to invest their money and receive a return that at least matches and hopefully surpasses inflation. Securities markets are also important for serious funded pension reform. "Pillar two" and "pillar three" pension reform typically envisions individual accounts where citizens' money is invested in the domestic securities markets, creating pools of capital that will be an engine for growth and reducing the burden on the pay-as-you-go ("pillar one") system.

Longer term, securities markets are important as a place where enterprises can raise money. Companies will be able to turn to the securities markets and accomplish initial public offerings or secondary offerings and raise capital for expansion and job creation.

Securities markets are also important because they provide an "exit strategy" for strategic investors. Strategic investors buy big blocks of shares and invest know-how and capital in enterprises. But such investors need an exit. In other words, assuming every aspect of the business plan goes well, how does the investor get his principal back and capture the return? If there are liquid securities markets where a public offering of shares can be executed in the future, this can provide the needed exit strategy, and (domestic and foreign) strategic investors will be more likely to invest in Ukraine.

Securities markets also provide a price discovery mechanism, which is particularly important for privatization. It is difficult to value enterprises being privatized. If some shares already are traded in the organized securities market, the State Property Fund (SPF) and potential investors are able to see how the market values a company – the opinions of hundreds or even thousands of investors are reflected in the stock price. The more liquid the market, which in part is determined by the percentage of shares already privatized and available for trading, the more accurate and hence valuable this price information will be.

Securities markets also play an important role in corporate governance. The price of shares of a company listed on a stock exchange rises and falls and thereby provides a kind of "report card" on management's performance. That is, if management performs poorly, or if a firm has poor corporate governance practices, shareholders "vote with their feet" (i.e., sell their shares) and this puts downward pressure on the share price. A lower share price, in turn, puts pressure on management to improve performance. The pressure is most acute, of course, if managers themselves own shares – then they personally feel the pain of the declining share price. Conversely, if managers of one firm see the managers of another firm with good corporate governance practices gaining wealth from the firm's rising share price, this will encourage these managers to introduce good corporate governance practices at their own firms.

In addition, although it has not happened in Ukraine yet, a "hostile take-over" is theoretically possible if the share price becomes cheap enough. In this case, management can be fired by the new owners. Moreover, the fear of this possibility can be an effective incentive for management to perform.

One of the most important functions of securities markets in a country such as Ukraine is as a facilitator of post-privatization corporate restructuring. Restructuring should occur when "efficient owners" (mostly strategic investors but also portfolio investors who have a big position and who are "locked-in" to their investment by an illiquid stock market) appear with large enough blocks of shares to insist on real change at companies. Unfortunately, perhaps out of fear of repeating the mistakes made in Russia's large-scale mass privatization program where new owners mostly looted the enterprises, Ukraine has insisted on privatizing large enterprises step by step, refusing to offer controlling blocks of shares. This incremental approach is one of the main reasons why privatization has not brought the benefits in Ukraine that privatization has brought in the West and in some other transition economies. Securities markets are therefore crucial to facilitate the accumulation of large block of shares that can be transferred to new owners who will contribute know-how and additional capital, and who will insist on real change.

The Securities Markets in Ukraine. The securities markets in Ukraine are under-developed and over-regulated.[64] An estimated 80-90 percent of trades in securities are settled outside of Ukraine.[65] Transparency is low – PFTS accounts for approximately 95 percent of the reported secondary market trading of shares, but this involves only an estimated 15-20 percent of all transactions concluded.[66] The rest of

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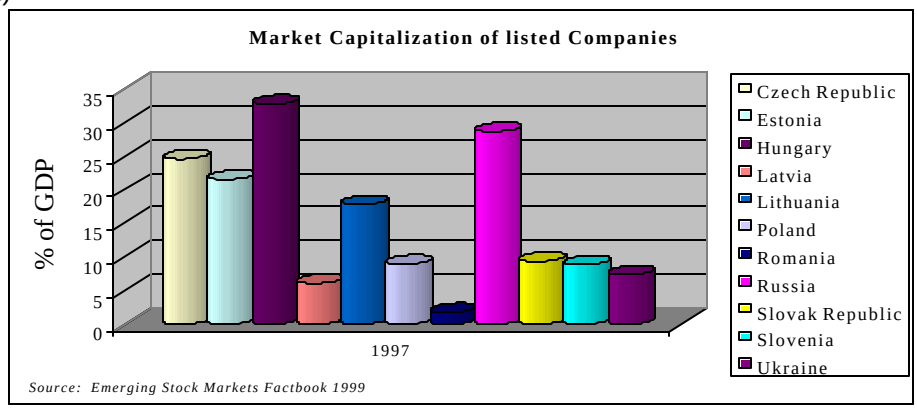
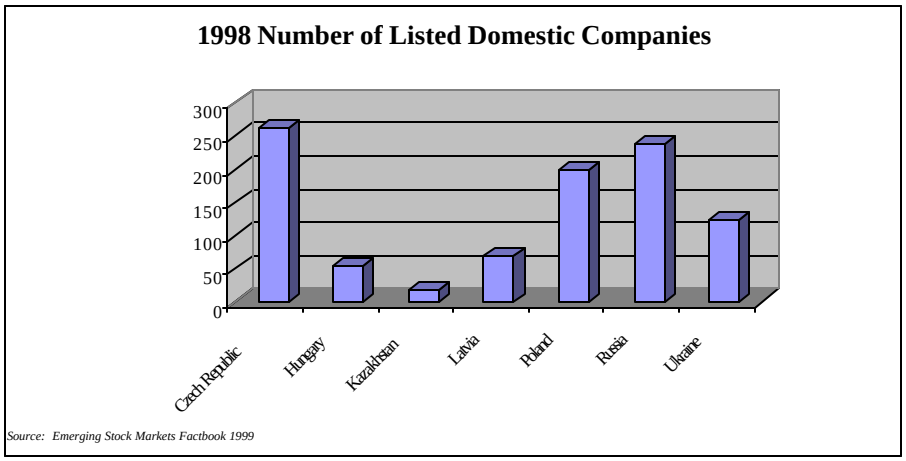
[64] The securities markets are actually over-regulated and under-regulated at the same time. On the one hand, market participants are subject to burdensome requirements that do little to protect investors. On the other hand, insider trading and market manipulation are insufficiently policed.

[65] Trades in shares of listed companies that are settled offshore are sometimes reported to PFTS. The primary motivation appears to be to improve the ranking of the broker in PFTS's monthly listing of the most active brokers.

[66] PFTS is an SRO of 274 brokers (out of approximately 850, many of which are inactive) thatoperates a nation-wide electronic trading system. The PFTS system is legally a "Trading and Information System (TIS)" rather than a "Stock Exchange," although it makes little difference in practice. PFTS market capitalization was Hr 10.5 billion ($2.1 billion) at the end of 1997, but fell to Hr 7 billion ($1.4 billion) by the end of 1998. Average monthly trade volume increased through 1999, however, with Hr 30 million ($6 million) per month traded on average during the first three quarters of 1999. Annual

transactions are concluded outside of the organized market. The market today is mostly a market for consolidation of control of "strategic" enterprises (in contrast to a mature market where the majority of transactions involve investors seeking dividends and/or capital gains). Partially as a result of the 1998 crises in Asia and Russia, and for other reasons specific to Ukraine, the volume of trade and valuations of securities are low, with little interest from either strategic or portfolio investors. To make matters worse, market manipulation is reported to be widespread with respect to the trading that does occur on the organized market, and many transactions in securities are purportedly based on insider information (information not widely available in the market).





Even though many professional market participants left the market as a result of the 1998 crisis, the securities markets remain decentralized, with many more broker-dealers and registrars than are justified by market activity. Too many broker-dealers and registrars are undercapitalized, inexperienced and/or unreliable. More generally, the level of professionalism and training of all types of professional market participants, and individual specialists within these firms, is low. In addition, infrastructure risk in the market remains high. There is not yet a reliable clearance

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trade volume on PFTS increased from Hr 338.5 million ($67.7 million) in 1998 to Hr 1 billion ($200 million) in 1999. Ukraine also has several stock exchanges – the two most active are the Ukrainian Stock Exchange and the Ukrainian Interbank Currency Exchange (UICE) – which are involved primarily in SPF cash auctions. During the first six months of 1999, shares worth a total of just under Hr 52 million ($10.4 million) were sold in initial offerings by the SPF via stock exchanges. The UICE is also trying to increase its position in secondary market share trading. In total, there are six registered stock exchanges and three trading and information systems in Ukraine.

and settlement depository, and broker-dealers complain that agreed-upon trades are often broken (i.e., fail to settle) by the other party, without consequence.

The Asian Crisis

The contagion that rippled through the emerging market universe during 1998 severely crippled capital flows. Preliminary estimates by the World Bank indicate that net portfolio flows to emerging markets plummeted to just $14.1 billion in 1998, the lowest level since 1992. The $14.1 billion total registered during the year was less than half of the 1997 total and only 29 percent of the total portfolio flows recorded in 1996.

Emerging Stock Markets Factbook, 1999

For these reasons, in part, Ukrainian investors are wary of securities markets for savings; there is a flight of domestic capital to overseas markets; foreign investment is not flowing into Ukraine; collective investment institutions are not developing; and shareholder enforced restructuring is limited. The situation needs to be reversed or Ukrainian companies will be deprived of the investment that they need to modernize and grow, and the securities markets themselves will be deprived of the volume and corresponding revenues that securities markets need to prosper. Ukraine is an industrialized country of just under 50 million people. It is certainly reasonable for Ukraine to aspire to develop into an independent financial center with on-shore securities markets, using only those elements of foreign financial markets that maximize its competitiveness. Clearly, reaching this goal presents substantial challenges.

Guidelines for Securities Market Development. If securities markets are to contribute to the "culture of *confident expectations*" about transactional activity that is essential to financial markets development, they must be:

- reliable and safe
- liquid
- efficient
- transparent
- fair
- orderly

1. Reliable and Safe: A market is reliable and safe if post-trade infrastructure provides dependable processes for settlement of securities trades and safekeeping of securities and cash. Perhaps the most important factor in determining whether investors have confidence in a market is their trust in the basic elements of market infrastructure. Investors will not consider investing in a market unless they are sure that market infrastructure is sound, transparent, fair and operates according to clear rules. It does not matter how profitable a company is if an investor is uncertain that his ownership of the company's shares will be properly recorded and that he will be able to sell the shares easily when he desires.

Unfortunately, Ukrainian securities markets are not yet reliable and safe. Clearance and settlement of corporate shares, in particular, is decentralized and nonstandardized, with different and often onerous processes used to settle transactions in the shares of different issuers. Settlement requires preparation of numerous documents and a time-consuming trip to the company registrar to complete re-registration. Settling securities transactions can take weeks, with each investor

and counter party having to essentially create their own private delivery-versus-payment mechanism, varying depending on the registrar involved. [67]

Policymakers should encourage the process of consolidating and upgrading registrars into a few restructured entities connected to a depository. The overall number of registrars should be reduced greatly.[68] The dominance of certificated securities in Ukraine, both bearer and registered, contributes to settlement inefficiency and risk, and therefore securities should gradually be immobilized and dematerialized in a depository or custodian (a "depository institution").

A healthy custodian industry is vital for safekeeping securities of individuals and institutional investors (including investment funds and non-state pension funds). The custodian industry will also be a vital part of the clearance and settlement system. Finally, custodians are necessary in order for foreign portfolio investors to invest in Ukraine, whether through investment funds, depository receipts, or individualized global custody arrangements. The operations of most custodians in Ukraine (there are 72 licensed custodians) need modernization to bring them closer to international standards.[69]

A safe and reliable clearance and settlement depository linked to the main trade organizers would give investors confidence that their share ownership will be accurately recorded and safeguarded, and that they will receive the benefit of the bargain that they made on *trade date* – i.e., that securities will be transferred and payments received on *settlement date* efficiently and safely, regardless of what happens to the counter party.[70] Efforts are presently underway to develop a participant-governed depository, clearance and settlement system in Ukraine, the "All Ukraine Clearing Depository (AUCD)," based on the "Inter-Regional Stock Union (MFS)," which should be encouraged and supported.

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[67] Registering share ownership can also be difficult because of the existence of pocket registrars – share registries under the control of issuer management – that engage in such practices as delaying the entry of names of unwanted new shareholders into the registry and denying shareholders the ability to exercise the rights inherent to share ownership (e.g., by claiming that a shareholder was not registered at the time notice of a general shareholders meeting was given). Efforts to enforce compliance with regulatory norms by these pocket registrars should be increased, minimum standards raised, and true separation of registrars from issuers compelled.

[68] Ukraine has approximately 375 independent registrars, while Russia has approximately 120 and Poland has zero (shareholder lists are maintained instead by a depository in Poland).

[69] A reasonable and consistent legislative and regulatory framework for the activities of registrars, custodians and depositories is also needed. The existing legislation either fails to, or inconsistently, addresses the operational issues facing these institutions. This includes: i) proper handling of security certificates, as well as rights to immobilized securities, to verify and protect ownership interests; ii) the absence of well defined legal concepts of "trust," including trustees, trust companies, fiduciary duties, etc.; iii) when shares are sold, absence in the legislation of a clearly defined moment when the "rights" and/or "property" are transferred (i.e., trade date or settlement date); iv) proper verification and protection of the ownership rights of non-resident shareholders of Ukrainian companies; v) the legal force of electronic documents and electronic signatures; and vi) the authority of non-bank custodians to handle money so that they can offer their customers "individually managed accounts."

[70] Imagine that the market drops precipitously between trade date and settlement date. On settlement date, the buyer will be receiving shares worth much less than he is paying. The buyer has a strong incentive not to perform in this situation, and thus effective mechanisms are crucial to ensure that such a trade settles as agreed.

It will be difficult, however, under present market conditions to develop a fully functional clearance and settlement depository that guarantees share transactions and mitigates counter-party risks. Initially, therefore, the AUCD may function more as a "central share re-registration facility."[71] By this, we mean that it will act as a nominal holder, allowing re-registration of all eligible securities in one central location. Yet even this will greatly reduce the settlement cycle by standardizing re-registration procedures and eliminating the need to travel to independent registrars around the country. Policymakers and private sector participants of the AUCD need to work to bring settlement on-shore, so that a fully functional depository, clearance and settlement system for shares can be developed. In general, the goal should be to create a settlement system and legal environment that will attract (not force) trading on-shore. That is, negative incentives, such as strictly tying re-registration of shares to payment, are less desirable than positive incentives, such as reducing the settlement cycle to three days to reduce exchange rate risk, and reducing the taxes associated with securities ownership.[72]

The Group of Thirty Working Group on Clearance and Settlement has recommended that there should be only one depository per country. The primary reason is risk recognition – a single depository can effectively monitor each participant's accounts for unusual activity, such as a concentrated position in one security or projected cash settlement debits that appear particularly high. Conversely, if a participant has accounts in several depositories, no one depository will have the information necessary to monitor the overall risk exposure of that participant. Unfortunately, Ukraine currently has two competing potential depositories for shares, the AUCD and the National Depository of Ukraine (NDU). Further, a third potential share depository is in the planning stages.[73] The NDU is legally confined to three narrow, non-commercial functions, pursuant to a memorandum of understanding signed by the Government of Ukraine (GOU), but nonetheless has made its intentions to move beyond these three functions obvious to all. The

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[71] A depository operating at the lowest level of service operates as essentially a "central share re-registration facility." It does not clear and settle trades, but simply reduces the burden on market participants imposed by a system where independent registries are scattered throughout the country. At the next level, a depository offers "trade-for-trade settlement," with accounting and control processes to facilitate "delivery versus payment" between the parties to the trade. At this level, settlement remains strictly between buyer and seller – the depository does not guarantee settlement or net either securities or funds in the settlement process ("delivery versus payment" means that neither party is at risk of non-performance by the other party– i.e., securities are not delivered before the funds are received, and vice versa). Finally, at the highest level, a depository guarantees (net) settlement. At this level, the depository guarantees the delivery of securities that have been bought and paid for and takes responsibility for the situation when the sold securities are not, in fact, delivered by the selling broker (or its customer). Similarly, the depository guarantees thedelivery of funds for securities that have been sold and delivered. If the depository is to guarantee settlement, it must be in a financial position to cover any defaults by participants, which generally requires that participants contribute to a "settlement guarantee fund" so that the depository has a reserve of cash to draw upon as needed.

The AUCD system currently in place has the capability of providing all of these features, although some features will initially not be "turned on." Industry participants, AUCD management, and policymakers must work to make the changes necessary in order to activate all of the system's features.

[72] See also footnote 82.

[73] The "Ukrainian Depository," backed by several stock exchanges, plans to apply soon to the SSMSC for a clearing and settlement depository license.

situation has unfortunately become extremely politicized, is seriously harming the market, and must be quickly changed. The presence of the NDU looming over the AUCD creates great uncertainty and destroys the confidence market participants would need before they commit time and money to the AUCD (or, for that matter, to the NDU).

The solution is to merge the NDU and the AUCD*, but only on the basis of statutory documents that separate Government ownership from control* This last point is crucial – private sector participants will not have the necessary confidence in the merged institution unless they alone manage and operate it and have the majority of the seats on the supervisory board.[74] The Government should regulate the institution to ensure that it is safe and reliable, but not operate it or control the supervisory board.[75]

2. Liquid: Market liquidity gives an investor confidence that securities can be readily purchased and sold – that there will be enough buyers and sellers available to provide easy entry and exit from the securities market. Liquidity is typically defined by three characteristics:

- *depth*: that the market has orders available at prices above and below the current equilibrium price;
- *breadth*: that the market can absorb large orders without large price changes; and
- *resiliency*: that the market quickly attracts new orders after price changes.

Ensuring sufficient liquidity should be a central goal for trade organizers and Government policymakers because its existence can be determinative for investors. Every direct strategic investor, for example, wants to know that he has the possibility of exiting his investment in the future. And liquidity is even more important for portfolio investors because they expect to enter and exit from investments in shorter time frames.

But liquidity is not a system that can be purchased. Liquidity must be carefully nurtured.[76] Liquidity follows from decisions by trade organizers and Government

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[74] Provisions should be included in the merged institution's statutory documents to allow private sector participants to automatically buy out the Government's interest on specified terms. In addition, the statutory documents should limit the ownership stake of all current and future private-sector participants so that no one market participant can exert undue influence over such a key component of market infrastructure.

[75] Market participants generally place more trust in systems that they themselves control. Moreover, such systems are often more economical and efficient because participant-owned organizations have strong, profit-maximizing incentives to quickly find workable, cost-effective solutions to problems that arise (i.e., maximizing the participants' profits – the depository itself should be non-profit). Finally, if the Government manages or operates the depository, then the Government will essentially be regulating itself which amounts to a conflict of interest. (A market participant SRO, by comparison, is subject to oversight by a higher authority.)

[76] The SSMSC passed a Decision requiring all trades, above a threshold Hrivna amount, in shares of certain enterprises "attractive for investment" to occur on a stock exchange or electronic stock market. The criteria for determining what enterprises are "attractive for investment" include profitability, number of shares outstanding, number of shareholders, and minimum assets. This is an important first step by the SSMSC toward increasing market liquidity and transparency with respect

policymakers, including listing requirements, tax policies, capital repatriation, privatization, transparency, trading rules, investor restrictions, clearance and settlement, custodial protection and a host of other factors that affect the level of participation in the market. In Ukraine, the slow pace of large-scale strategic privatization is perhaps the most significant factor affecting liquidity because there are too few shares of companies in circulation. Nurturing and sustaining market liquidity is a difficult and constant challenge.[77]

Liquidity (and transparency) can also be improved by stock indexes, such as the various indexes on PFTS-listed stocks, and multiple listing tiers, such as exist already on several exchanges and electronic stock markets. Indexes allow investors to judge the overall movement of the market and can increase trading volume in the shares included in the indexes. Eventually, derivatives on such indexes could allow investors to hedge overall market risk, encouraging participation in the market and increasing liquidity. Establishing different "listing tiers" can contribute to market liquidity by reducing investors' research costs and encouraging investment in listed securities. If a company is listing in one of the higher tiers, an investor knows, without further research, that the issuer has met certain measurable standards. Listing tiers and indexes are private sector initiatives that policymakers should encourage but not mandate.[78]

Finally, "market makers" who support the liquidity of specific securities in the secondary market by always keeping an inventory of those securities and posting two-sided quotes are a device used in many markets (including PFTS) to increase liquidity.[79]

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to the largest blue-chip companies. (SSMSC Decisions No. 250, December 30, 1998, and No. 141, July 6, 1999).

[77] Government policies clearly affect stock market liquidity. For example, Hungary (like Ukraine) offered high yields on Government debt instruments to capture funds, but the yields were so attractive that they discouraged investors from buying equities. The Egyptian Government was recently so eager to ensure the successful privatization of several prestigious State enterprises that it guaranteed share buyers an attractive dividend rate of 12%, which had the immediate effect of devastating the existing securities market as investors sold their shares to use the proceeds to buy these new Government guaranteed shares. Because of the dramatic impact that Government policy decisions can have on securities markets, trade organizers and SROs must vigilantly clarify for policymakers the possible adverse consequences of proposed Government actions. The point is that stock market liquidity is as delicate as it is essential.

[78] In early 1998, the PFTS Stock Index was listed in the International Finance Corporation's (IFC) world-wide Frontier Index.

[79] Market design is a complex subject, beyond the scope of this Paper. In general terms, however, markets are often considered either "order-driven" or "quote-driven." In an order-driven (or "auction") market, brokers initiate trading by revealing their orders to buy or sell securities at specific prices. In a quote driven (or "market maker") market, market makers compete for orders by publishing bid (buy) prices and ask (sell) prices. Markets are also categorized as "continuous" or "call." In a continuous market, orders are executed at any time when a buy order price equals or exceeds a sell order price. In a "call" market, on the other hand, buy and sell orders are accumulated over a specific period of time and executed simultaneously when a market-clearing price is established – that is, when the market is "called." Any of the above market designs can utilize a physical trading floor, or can be conducted over a computer network linking brokers at different locations. Markets often combine these various features, perhaps using an automated "order match system" (a computerized quote-driven system that automatically matches and executes buy and sell orders) for frequently-traded securities and a market maker system or a call market for thinly-traded securities.

3. Efficient: An equity market is "efficient" if share prices reflect all obtainable information. In an efficient market, prices should (in theory) change only when new information becomes available. A goal of policymakers and trade organizers should be to increase the efficiency of markets by improving the availability of information. One way to increase market efficiency is to improve issuer disclosure. This means more complete and accurate periodic reports and special reports filed with the SSMSC and made public. In addition, issuers should be encouraged to begin releasing information that could affect the price of their shares directly to the market in press releases.

Collective investment institutions and institutional investors can increase market efficiency because their size and expertise gives them better access to information. If, for example, based on the information they have been able to acquire, prices appear too high, they will increase the efficiency of the market by selling shares and putting downward pressure on prices. Market efficiency is also increased whenever anyone gathers and disseminates information about issuers or factors effecting the market generally. This includes: market analysts, credit rating agencies (e.g., Fitch, Moody's, Standard & Poor's), the financial press, buying and selling by insiders, public releases by the GOU of information affecting interest rates, currency exchange rates, wire services (e.g., Reuters, Interfax Ukraine), web sites maintained by various organizations,[80] the SSMSC's Public Information Office, and listing standards of stock exchanges and electronic stock markets. Policymakers should find ways to encourage these activities whenever possible.[81]

4. Transparent: Market "transparency" refers to dissemination of information about prices, volumes and trades in securities. Accurate and timely information (i.e., a high degree of transparency) increases the efficiency and liquidity of the market. At a minimum, transparency requires that timely price and volume information be readily available.

Many securities in Ukraine are not listed on any exchange or electronic stock market, and thus no price or volume information is available. Even for listed securities, securities traders often do not report their trades, or report false information. In addition, many trades in listed securities occur without using the services of a securities trader and are not reported for this reason. As a result of these factors, the price and volume information made available by trade organizers is limited and not fully accurate. As a first step, it is imperative to ensure that securities traders fulfill their existing legal obligations to report all trades in listed securities to the exchange or electronic stock market where the security is listed.[82]

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[80] Important web sites are maintained by: the State Property Fund (mass privatization) www.spfukraine.com; Ukrainian Financial Server www.ufs.kiev.ua; PFTS www.pfts.com; Informational Agency "Infinservice" www.ifs.kiev.ua; UAIB www.uaib.ukrpack.net; and the SSMSC's Public Information Office www.pio.kiev.ua.

[81] Buying and selling by insiders, of course, need not be encouraged by policymakers although it does increase the market's efficiency because of insiders' informational advantage over average investors. Such buying and selling should be restricted completely, in fact, when insiders are in possession of material, non-public information ("insider trading").

[82] Encouraging traders to report their trades can be accomplished using a carrot and stick approach. Positive incentives include methods such as PFTS's publicizing the list of traders reporting the most trades in each month (a form of free advertising). Another positive incentive will exist once a clearing and settlement system is cost effective so that it is cheaper for a trader to report a trade and use the

Further transparency is possible as the market develops.[83] For example, the number of listed securities could be expanded, perhaps through the development a "bulletin board" system where price and volume information is reported not in real time (once a day or once a week) for thinly-traded securities. This would allow investors to have access to at least some information on these additional securities.

There is variation in the amount of transparency required in different markets. For example, some markets make their limit order books available to the public to increase transparency, while other markets purposefully do not require that limit order books be made public to give a competitive advantage to market makers so that they can better do their job of bringing order and liquidity to the market.[84] And some markets allow large block trades to be executed off-market and reported on a delayed basis to give traders time to execute the full block without driving prices up or down. There are legitimate policy arguments for these various rules. The point is that increased transparency should be the goal, and any deviation from full transparency must be carefully considered and justified.

5. Fair: The fairness of a market refers to whether all members are treated equally and reasonably. For example, the rules of a market should provide for dues and other charges that are reasonable and that are allocated in an equitable manner among members and others using its facilities. In addition, any prospective member who meets the capital and other regulatory requirements for participation in the market, and agrees to abide by its rules, should be entitled to membership. The sanctions that the market is authorized to impose on its members should be reasonable and members should be guaranteed due process, including the right to appeal the imposition of a sanction to the government regulator or to a court. Similarly, the regulations adopted and enforced by the government regulator should be reasonable and evenly applied to all market participants.

6. Orderly: Orderliness refers to the adequacy of a market's customer protection rules, trading rules, market monitoring, and enforcement mechanisms. Orderly markets have clear *customer protection rules* to prohibit manipulative or abusive practices such as front running,[85] insider trading, market manipulation, and fraudulent sales practices, as well as *trading rules* requiring traders to have adequate capital and prohibiting traders from backing out of trades or not honoring firm quotations. These rules must be enforced, which requires the capacity to monitor the market, investigate and impose sanctions. Markets should have this capacity

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system to clear and settle it. If re-registration of ownership occurs at depository institutions rather than at registrars, this can also facilitate automatic reporting of trade information. Negative incentives include methods such as stricter inspections and sanctions by the SSMSC and SROs for non-reporting of trades (SRO rules and Article 29 of the law "On Securities and the Stock Exchange" require reporting of trades). The SSMSC's Decision, discussed in footnote 76 is also an effective negative incentive.

[83] PFTS's monthly rating system listing the most actively traded shares in descending order is an example of a mechanism designed to increase market transparency. The system uses a mathematical formula based on four parameters: the total Hrivna value of trading in a security; the number of trades; the size of the spread between the best bid and offer quotations; and, the total number of quotations in the system for that security.

[84] A "limit order book" is the list of orders from customers to buy or sell a security at a given price or better.

[85] "Front running" refers to a market professional making a trade for his own account while holding and not yet executing a large order on behalf of his client, knowing that he will thus benefit from the price change that his client's order will cause.

themselves, operating as self regulatory organizations (SROs), and not rely entirely on the Government securities regulator to perform these functions.[86]

Cross-border Linkages. There is a trend internationally toward mergers and cross-border linkages of securities markets and post-trade facilities. Moreover, in Europe the Euro launch has added to integration pressures. As the securities markets in Ukraine continue to develop, consideration of integration with other markets will no doubt occur. Ukraine's markets would be advised to follow the historical formula for success: to first focus on succeeding locally, then regionally, then nationally, and then internationally. While there would be benefits to ultimately linking cross-border, particularly in terms of increased liquidity, the downsides need to be carefully considered as well. Premature linkages, before Ukraine's markets are safe, liquid, efficient, transparent, fair and orderly in their own right, could result in a loss of national securities markets to stronger markets abroad. Cross-border linkages work best when the partners in such a link participate as peers.

Securities Legislation and the SSMSC. It has been demonstrated internationally that a strong, independent Government regulator is critical to successful securities markets development. The early history of securities markets in today's industrial economies – before the establishment of a strong securities regulator – is replete with scandals that undermined confidence in these markets. Typically these episodes led to long periods where the securities markets ceased to be a significant source of capital for companies. In addition, it increases regulatory efficiency if the expertise to regulate the securities markets is consolidated in one government agency. For example, one government agency should be responsible to investigate market manipulation whether it involves treasury bills, bonds, shares, negotiable instruments (veksels), or futures contracts.[87] When properly implemented, securities market regulation helps create an environment of *confident expectations* among domestic and foreign securities markets participants and potential investors, lowers the cost of participation in the securities markets, and opens up the markets to participants who otherwise would not have the expertise or the financial ability to enter the market.[88]

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[86] Although the discussion of SROs in the text focuses on trade organizers, clearance and settlement depositories should also operate as SROs. Trade organizers and clearance and settlement depositories are sometimes called "natural SROs" because their members enter into transactions with each other, and thus have an incentive to monitor each others' behavior. SROs should have both customer protection rules and trading rules, although they have a greater interest in, and thus will generally be more effective at, enforcing the latter. Perhaps for this reason, countries that have moved away from reliance on SROs, such as the Netherlands, nonetheless continue to rely on SRO enforcement of rules governing participants' interactions with each other.

[87] It does not necessarily follow that the securities market regulator should register all of these types of securities. Treasury bills, for example, probably need not be registered with the securities market regulator.

[88] Securities regulation should comply with the "Objectives and Principles of Securities Regulation" adopted in Nairobi in September 1998 by the International Organization of Securities Commissions (IOSCO) (www.iosco.org/docs-public/1998-objectives-document). The government securities regulator should focus on: i) protection of investors; ii) maintenance of liquid, efficient, transparent, fair and orderly markets; iii) ensuring safe and reliable clearance and settlement of securities transactions (e.g., with system parameters that are adequate for peak loads and disaster recovery); iv) reduction of systemic risk; v) full and accurate disclosure of information by actively traded companies; vi) prohibition of fraud; vii) avoidance of unnecessary burdens on the market; viii) creating equal conditions for all market participants and institutions; ix) sound corporate governance;

In 1995, the Verkhovna Rada adopted the "Concept for Functioning and Development of the Securities Market in Ukraine," which defined as its goal the achievement of a "consistent, transparent, highly liquid, effective and fair securities market." The SSMSC was established by presidential decree in June 1995, and given a broad mandate in October 1996 by the law "On State Regulation of the Securities Market in Ukraine." The SSMSC has made considerable strides in the past few years to begin to fulfill its assigned functions. More can be done, however, so that the SSMSC fully protects investors and fulfills its other tasks. Policymakers in Ukraine need to seriously consider ways to strengthen the SSMSC. First, the SSMSC and its regional offices must receive funding adequate to perform the necessary tasks. This is not the case today. Further, an exemption from Government compensation scales may be necessary to allow the SSMSC to hire and retain qualified staff.[89] Without a world class regulator, securities markets development will suffer.

Presidential Decree on Stock Market Development in 2000. On October 30, 1999, President Kuchma issued a decree "On Guidelines for Stock Market Development in the Year 2000." The Decree is a positive step toward further developing the securities markets in the coming year. Among other things, the decree calls for: i) introduction of a system of securities codification in compliance with international standards; ii) creation of a database of issuers' reports so that information in compliance with international standards is made public;[90] iii) creation of a database of securities market violations; iv) making public information on the activities of market participants; and v) furthering creation and functioning of public organizations addressing protection of investors' rights. We urge swift completion of the items in the decree.[91]

Securities Law. In addition to improving the securities regulatory structure, the legal basis for the securities markets also needs to be improved. In most CIS countries, the securities markets are governed by one law, whereas Ukraine has three laws: "On State Regulation of Securities Markets in Ukraine," "On the National Depository System and Electronic Circulation of Securities in Ukraine," and "On Securities and the Stock Exchange." Ideally, these three should be combined in one new law, although this may prove politically difficult. At a minimum, a new law to

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x) licensing, monitoring and sanctioning of professional market participants; and xi) encouraging the development of necessary market infrastructure.

[89] Employees of securities market and banking regulatory agencies in the United States, for example, receive higher wages than employees of most other Government agencies.

[90] Issuers' reports are currently made available to the public through the SSMSC's Public Information Office (PIO), but the system needs improvement, including completing the move to electronic filing and public access via the Internet.

[91] One exception is Item 2, paragraph two of the Decree, which calls for simplification of the procedure for creation of joint stock companies by uniting the procedures for State registration of the company itself as a legal entity, registration of the share issuance, and registration of the offering prospectus. Combining the second two registrations would be a positive step, but it would be a mistake to combine the first registration with the second two. State registration of a company as a legal entity is required for all legal entities, big or small. The purpose is to protect creditors and transactional counterparties – the registering authority ensures that the company is properly formed and the statutory capital paid in. SSMSC registration, on the other hand, should be reserved for open joint stock companies offering shares to the public (this would require a change in law to exempt closed companies). The purpose of registration with the SSMSC is to ensure that all material information is disclosed to investors in public companies before the investors make a decision to purchase shares. Both Germany and the United States follow this division of authority.

replace the 1991 law, "On Securities and the Stock Exchange" should be finalized and passed as soon as possible.[92]

Regulatory Activities of the SSMSC. Small companies are over-regulated by current law and by the SSMSC.[93] The focus of both law and regulation should be on the market for the securities of large, actively traded companies. This widely-dispersed, public market requires the focus of the SSMSC to protect investors. Only in this market do the benefits of Government regulation outweigh the costs. Unfortunately, current law requires that the SSMSC register share issuances of even small closed joint stock companies where there is no public offering and no public trading of shares. This problem is compounded by requiring that extensive documents be filed for such a registration. As another example, SSMSC regulations require that even small closed joint stock companies have a registry with a certified specialist.

The SSMSC also needs to review its regulatory requirements for all market participants. It currently has too many filing, registration, and other requirements, the costs of which outweigh the benefits. Unnecessary requirements should be eliminated. Going forward, the SSMSC should improve the transparency of its regulatory process through a strict procedure requiring publication of the text of proposed new regulations in the SSMSC's magazine "Ukrainian Securities," with a set period of time during which market participants can provide suggestions. The SSMSC should also make greater use of the Consulting and Expert Council to review and discuss draft regulations.

When a company issues shares, the process – including registration with the SSMSC of the prospectus and (later) the share issuance – is complex and time consuming, requiring as much as 270 days. This deters companies from raising capital through share offerings. The SSMSC has indicated on previous occasions that it wants to simplify the procedure, and President Kuchma's October 30, 1999 decree on the stock market calls for, among other things, uniting the registration of the prospectus and the share issuance. This is a positive development. In addition to simplifying the procedure, however, the SSMSC needs to clarify its policy regarding the criteria it will use in refusing to register an offering prospectus and/or a share issuance.[94] The SSMSC's policies regarding such refusals are now uncertain, making the process costly for issuers.

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[92] Provisions of the law "On Securities and the Stock Exchange" should be amended and expanded to more accurately define securities and securities transactions; regulate securities offerings, secondary market trading, stock exchanges, electronic stock markets, self regulatory organizations, and professional market participants; require regular and special disclosure of material information by issuers of securities; require disclosure regarding ownership of large (over 10 percent) blocks of shares; and provide protections against insider trading, market manipulation, fraud in the purchase and sale of securities, and unfair advertising in the securities markets.

[93] The SSMSC feels that it must respond to the many requests for assistance that it receives each week from shareholders of small companies. We urge the SSMSC, however, to simply respond with a form letter to companies with less than 500 shareholders, and focus its resources instead on larger companies.

[94] The SSMSC recently began providing a written explanation in each case explaining why an offering prospectus or share issuance was rejected. This is an important improvement, but it is not sufficient. More clarity is needed regarding the possible grounds for refusal.

The SSMSC also needs to improve its review of issuer annual and special reports. Current practice involves making sure that all tables have been completed and financial statements included. A more thorough review will be required, however, to improve compliance with the new National Accounting Standards and generally to ensure disclosure of all facts about the activities of an issuer that could significantly affect the market value of its securities ("material information") in narrative and numerical form. Penalties for provision of incomplete or false information also need to be increased (by law).

The SSMSC's enforcement department has made good progress, developing in just three years into a fully functional program that has uncovered thousands of violations and imposed appropriate sanctions. But more needs to be done.[95] Too many enforcement cases are for technical violations that have no direct effect on the market.[96] In this regard, the SSMSC is similar to the NBU, and, we suspect, similar to many other Government agencies in Ukraine (Box 4.2). In addition, regional SSMSC offices have little knowledge of cases and priorities of the central office, or of other regional offices. And market participants receive little guidance on what the SSMSC regards as the most serious violations. While the SSMSC does release information to the market, it should increase these activities, saturating the market with information about its enforcement actions.[97] The SSMSC must work to earn a reputation as the protector of the market and of investors' rights.[98]

Licensing. Prior to October 1996, the Ministry of Finance (MOF) had authority to license broker-dealers, and it licensed many more than could reasonably operate in the fledgling market. After October 1996, the SSMSC took over this licensing responsibility and, unfortunately, continued this tradition. There are currently approximately 850 broker-dealers, approximately 375 registrars, and, incredibly, 8 trade organizers and 10 SROs. Given the size of the Ukrainian market, these numbers should be perhaps a third what they are. The SSMSC sets licensing standards too low, and fails to protect investors by ensuring that only well-capitalized, qualified market intermediaries receive a license. Standards should be raised and licenses withdrawn from those not able to meet the higher standards.[99] In addition, the SSMSC needs to improve its monitoring of market intermediaries to ensure that they *continue* to meet licensing requirements.[100] The SSMSC may soon grant licenses to a new category of market professionals: investment advisers. If it receives this authority, we urge the SSMSC to avoid repeating the mistakes of the past and instead set high standards and restrict the issuance of licenses.

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[95] Currently, the SSMSC does not have enough qualified staff in its corporate finance and enforcement departments.

[96] Market intermediaries complain that SSMSC inspection and enforcement practices vary across the country, with limited opportunities to appeal decisions, making compliance difficult and operations expensive (due to unpredictable fines).

[97] The SSMSC issues regular press releases which cover enforcement-related issues, and makes information public via resolutions and orders regarding, among other things, revocation of licenses.

[98] The SSMSC should also work to improve the effectiveness of its regional offices.

[99] In addition, market participants complain that licensing requirements vary across the country.

[100] The fact that 850 broker-dealers are currently licensed is fairly persuasive evidence that that the SSMSC's on-going monitoring function is not being performed adequately. Many of these broker-dealers are not in compliance with regulatory requirements, and yet they retain their licenses.

Box 4.2

Enforcement

Implementing effective enforcement is one of the hardest parts of the transition from a centrally planned to a market economy. The old State machinery has disappeared with nothing in its place. Criminal investigators have been unable to solve even one high profile contract killing in Ukraine since independence. And the situation is worse in administrative agencies with law enforcement responsibilities. Such agencies do not have the ability to attract and retain the qualified lawyers, auditors, investigators, and IT experts necessary to conduct complex investigations and bring actions in court. They often are hampered by inadequate budgets, even for such things as basic office supplies.

In addition, civil law enforcement agencies are not given the powers necessary to effectively gather documents and physical evidence and take recorded testimony (See footnote 194). Further, they often are not given the power to impose appropriate sanctions – on a sliding scale – based on the seriousness of the violation. Thus, for example, an agency may only be authorized to suspend a license (a very serious sanction), but not to impose money penalties (potentially a light sanction). Sometimes an agency must first issue a warning, or an "instruction to remove a violation," and can only impose sanctions if this is ignored. But this two-step process can allow further harm to occur. When a violation involves illegally received money or property, agencies are not given the tools needed to seize these assets before they disappear.

Enforcement programs in Ukraine often seem to focus on procedural, technical violations rather than the larger, more substantive violations that do the most harm. Legions of inspectors drain the resources of law abiding companies attempting to comply with obscure regulations. Cynical observers sometimes suggest that this is the result of low paid civil servants trying to earn a living, but we suspect that it may have as much to do with a lack of tools that would be required to do more than police purely technical violations.

None of the securities markets activities licensed by the SSMSC are included in the list of such activities in the law "On Entrepreneurship," which, by its own terms, contains the complete list of licensed activities in Ukraine. For this reason, at least one market intermediary was able to successfully challenge in court the SSMSC's right to revoke its license (on the grounds that the SSMSC did not have the authority to issue the license in the first place, so it could not revoke the license). Lawmakers' intention with respect to the law "On Entrepreneurship" was to limit the Government's ability to haphazardly expand the list of licensed activities in cases when there is no public policy reason to require a license – a laudable goal. But securities market activities involve handling other people's money and therefore are licensed in all countries. Thus, the law "On Entrepreneurship" must be amended to add the securities markets activities.

Universal Banking. The SSMSC and the NBU are to be congratulated for making strides toward arriving at a proper jurisdictional split with regard to banks engaging in securities trading, trust operations, or custodian activities. This is an issue in every country with both universal banking and separate banking and securities regulators. Appropriately, jurisdiction between the SSMSC and the NBU is being divided according to *functions*, not according to entities. The NBU protects

depositors while the SSMSC protects investors; accordingly, each agency has a different expertise and a different focus.[101]

Universal banking invariably raises issues regarding conflicts of interest that can result when one entity performs multiple functions. The European Union Directive "On Investment Services in the Securities Field," dated May 10, 1993, 93/22/EEC, Article 10, states that investment firms [including banks engaging in securities trading or custodian activities] must:

> "be structured and organized in such a way as to minimize the risk of clients' interests being prejudiced by conflicts of interest between the firm and its clients or between one of its clients and another."

Compliance with this directive is generally thought to require that banks erect "Chinese walls" that limit communication of information between the various functions of the bank: lending, securities trading, and custodian activities.[102] Again, the NBU has taken steps to require such "Chinese walls," although more could be done to ensure compliance in practice.

Derivatives – Options and Futures Contracts. The jurisdiction of Government agencies in Ukraine with respect to derivatives is not clear.[103] In part, this in caused by conflicting legislation.[104] In part, it is caused by the fact that there is no bright line between the cash market (spot and forward contracts), which could be regulated by at least three different agencies depending on the type of asset involved, and the

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[101] The SSMSC should regulate and control the securities trading, trust operations, and custodian activities of banks, including record keeping requirements, trading rules, customer protection rules, periodic reports to the SSMSC, and certification of specialists. The NBU, however, should set and enforce capital requirements for banks engaging in securities trading, trust operations, or custodian activities.

[102] Examples of potential conflicts of interest include the following: if the lending department of a bank is worried about repayment of a loan by a client in poor financial condition, the securities trading department might be tempted to encourage that client to sell securities without disclosing all material information, because disclosing the information might cause the securities not to sell. Or a bank that has loaned money to a company might have access to insider information because of the debtor-creditor relationship that its securities trading department could use and thereby harm ordinary investors. If the bank acts as custodian for other securities traders and/or for investment or pension funds, the custodian department will have information about the purchases and sales of securities by these clients – its securities trading department could use this information to gain an unfair competitive advantage in the market.

[103] Derivatives are contracts whose value derives from the value of other securities, currencies or commodities; or contracts that confirm the right and/or obligation to purchase or sell securities, currencies, or commodities at some point in the future. Futures contracts and options are common types of derivatives.

[104] The law "On State Regulation of Securities Markets in Ukraine" indicates that the SSMSC is to regulate derivatives on all types of underlying assets: securities, currencies, and commodities. The law "On Introduction of Amendments to the Law of Ukraine 'On Enterprise Profit Tax,'" on the other hand, indicates that jurisdiction over derivatives is to be split between three agencies depending on the underlying assets. To add to the confusion, these two laws use two different terms: "deryvatyvy" versus "pokhidni" securities. Finally, Cabinet of Ministers (COM) Resolution No. 1928, dated October 19, 1999, states that the Agro-Industrial Complex Ministry will "approve the rules for issue and circulation of . . . derivatives, within the sphere of the exchange market, pertaining to underlying commodity assets."

derivatives market (futures contracts and options), which should be regulated by one agency, the SSMSC. In a transition economy, there will be a progression through several evolutionary stages, from:

- individually-negotiated spot and forward contracts that are not traded and result in actual delivery of the underlying asset; to
- standardized forward contracts that sometimes trade on an exchange and result in actual delivery of the underlying asset; to
- fully-standardized futures contracts traded on an exchange that are intended to hedge risk and almost never result in actual delivery of the underlying asset.

The SSMSC should regulate all trading in futures contracts once this third stage develops.[105] The modern trend internationally (in countries such as Hong Kong and Singapore, for example) is to have one government regulator for securities and all types of futures contracts. Solving this emerging jurisdictional puzzle will be a challenge for policymakers as the markets evolve.

Depository Receipts. Depository receipts here refers to securities issued in a foreign country based on shares of a Ukrainian company. The shares are held by a custodian in Ukraine that has a relationship with a foreign custodian bank issuing the receipts. Depository receipts make it easier for foreign investors to buy shares of Ukrainian companies. [106] We believe that the benefits of depository receipts for Ukraine outweigh the disadvantages, and thus policymakers should encourage their use. [107] Depository receipts increase liquidity, which is important to the home market. Some depository receipts involve not just expanded secondary market trading of shares abroad, but rather a primary offering that raises new capital for the Ukrainian company (for offerings in the US market, these are so-called "level three American Depository Receipts"). Moreover, depository receipts require Ukrainian companies to comply with international disclosure standards, accelerating the process of introducing international best practices in Ukraine. The primary disadvantage of depository receipts, on the other hand, is that they move trading and clearance and settlement offshore, hindering efforts to build market infrastructure in Ukraine.

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[105] The SSMSC should regulate trading of all types of futures contracts – licensing brokers and exchanges, approving exchanges' trading rules, approving new instruments for trading, investigating market manipulation, etc. As derivatives trading develops, however, another issue will emerge – the jurisdiction of the regulator of the underlying (actual) market of the proposed derivative contract. Derivatives can have a significant effect on the underlying market. Thus, for example, the Ministry of Finance (MOF) may want to review any new type of derivative instrument, the underlying assets of which are Government securities; the NBU any new type of derivative instrument, the underlying assets of which are currencies; and the Ministry of Economy or perhaps the Agro-Industrial Complex Ministry any new type of derivative instrument, the underlying assets of which are commodities.

[106] Depository receipts are essentially extracts (statements) issued by a global custodian in tradable form (a kind of "securitized custody").

[107] The President's October 30, 1999 decree on the stock market calls for "resolving the issues involved in attracting international investments to Ukraine through depository receipts."

Action Points:

- **Encourage the introduction of high standards for the activities of direct participants of the National Depository System with respect to recordkeeping of ownership rights to securities by introducing modern financial and informational technologies;**

- **Encourage the process of consolidating and upgrading registrars that maintain registries for listed companies into a few restructured entities connected to a depository. Greatly reduce the overall number of registrars;**

- **Enhance control over compliance with regulatory norms by *pocket registrars*, raise minimum standards for registrars, and compel true separation of registrars from issuers;**

- **Improve the legislative and regulatory framework for the activities of registrars, custodians and depositories (see footnote 69), and provide for the gradual immobilization of securities issued in documentary form while creating favorable conditions for securities to be initially issued in non-documentary form;**

- **Encourage the development of financially reliable domestic custodians capable of rendering a wide range of custodial services;**

- **In accordance with Group of Thirty recommendations, ensure that Ukraine has only one share depository by merging the National Depository of Ukraine (NDU) and the "All Ukraine Clearing Depository" (AUCD), and by advising the SSMSC not to grant licenses to any additional clearance and settlement depositories;**

- **Merge the NDU and AUCD on the basis of statutory documents that separate Government ownership from control. Ensure that private sector participants alone manage and operate the merged institution and have the majority of the seats on the supervisory board. Ensure that the Government regulates the institution to see that it is safe and reliable, but does not operate it or control the supervisory board. Add provisions in the merged institution's statutory documents to allow private sector participants to automatically buy out the Government's interest on specified terms, and to limit the ownership stake of all current and future private-sector participants, so that no one market participant can exert undue influence over the depository;**

- **Support efforts presently underway to develop a participant-governed depository, clearance and settlement system, the AUCD, based on the "Inter-Regional Stock Union" (MFS);**

- **Create a settlement system and legal environment such that cash settlements of securities transactions are performed primarily in Ukraine, not off-shore;**

- **Increase market *liquidity* by increasing the pace of large-scale privatization and examining other factors that affect liquidity such**

as listing requirements, tax policies, capital repatriation rules, transparency, trading rules, investor restrictions, clearance and settlement, custodial protection, and so on;

- **Increase market *efficiency* through improving public disclosure by actively traded issuers and by encouraging efforts to gather and disseminate information about issuers by, among others, market analysts, credit rating agencies, the financial press, wire services, organizers of web sites, and the SSMSC's Public Information Office;**

- **Increase market *transparency* by ensuring that securities traders report all of their trades in listed securities to the trade organizer where the security is listed;**

- **Increase market *fairness* by ensuring that the members of all trade organizers are treated equally and fairly;**

- **Increase market *orderliness* by establishing high requirements for trade organizers and depository, clearance and settlement facilities to operate effectively as self regulatory organizations, enforcing trading, reporting and customer protection rules. Encourage the future transformation of all trade organizers and clearing and settlement depositories into efficiently operating self regulatory organizations;**

- **Speed up completion of the items in the October 30, 1999, Presidential Decree "On Guidelines for Stock Market Development in the Year 2000" (in our opinion, however, Item 2, paragraph two of the Decree should be reconsidered -- the procedure for State registration of the company itself as a legal entity should not be combined with SSMSC registration of the share issuance and offering prospectus);**

- **Consider combining the three securities market laws – "On State Regulation of Securities Markets in Ukraine," "On the National Depository System and Electronic Circulation of Securities in Ukraine," and "On Securities and the Stock Exchange" – into one law, as in other CIS countries;**

- **At a minimum, finalize and pass a new version of the law "On Securities and the Stock Market";**

- **Narrow the focus of securities law and regulation to the market for actively traded securities where the benefits of Government regulation outweigh the costs;**

- **Encourage the SSMSC, in the course of improving its regulatory requirements for all market participants, to remove excessive requirements that do not significantly improve investor protection;**

- **Encourage the SSMSC to improve the transparency of its regulatory process through a strict procedure requiring publication of the text of proposed new regulations in the SSMSC's magazine "Ukrainian Securities," with a set period of time during which market participants can provide suggestions;**

- **Encourage the SSMSC to make greater use of the Consulting and Expert Council to review and discuss draft regulations;**

- **Simplify the process for a company to issue shares, and encourage the SSMSC to clarify its policy regarding the criteria it will use in refusing to register an offering prospectus and/or a share issuance;**

- **Encourage the SSMSC to improve its review of issuer annual and special reports to ensure disclosure of all facts about the activities of an issuer that could significantly affect the market value of its securities;**

- **Encourage the SSMSC to focus less on technical violations that have no direct effect on the market and more on substantive violations, and to increase its publication of information about enforcement actions;**

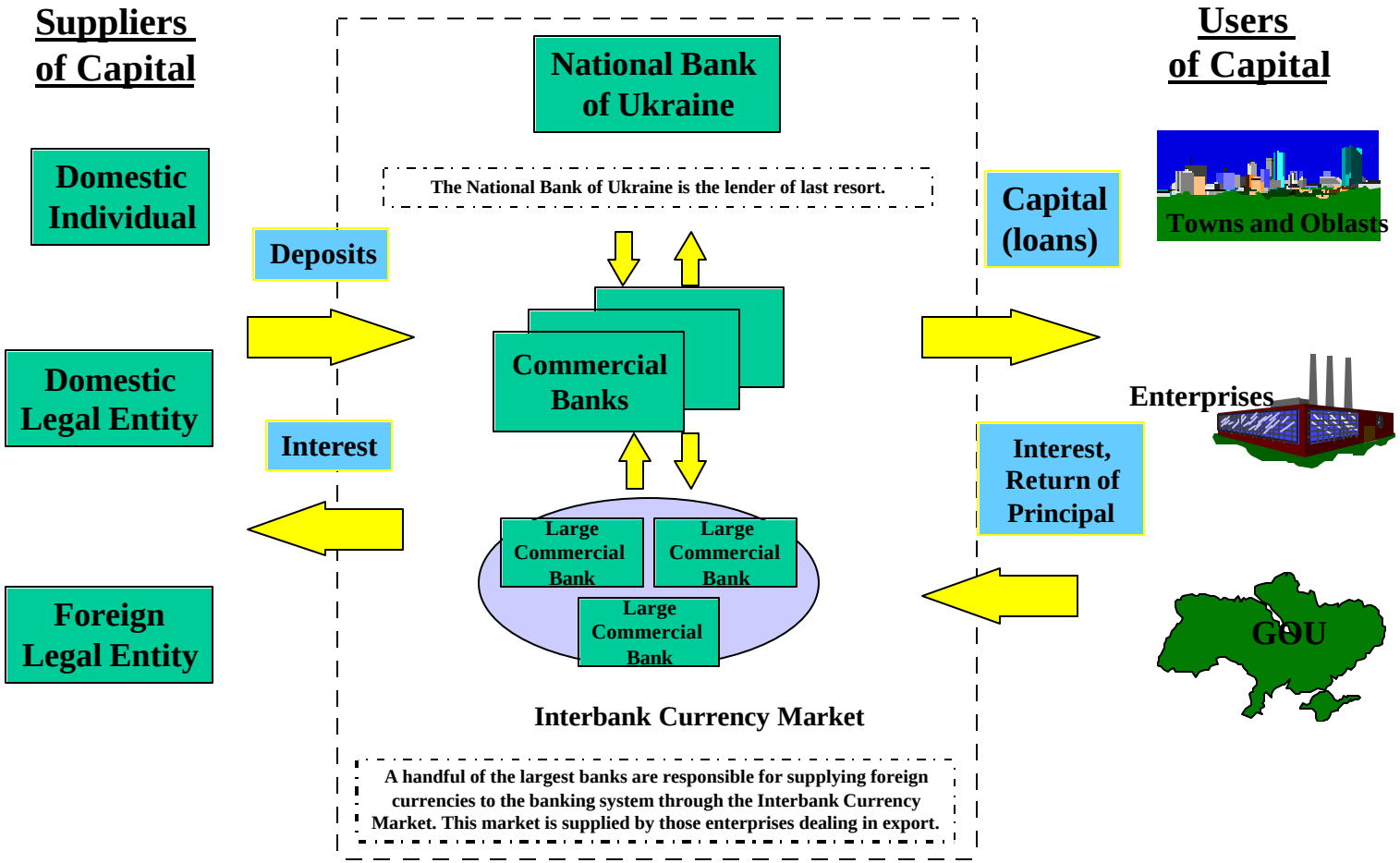
- **Encourage the SSMSC to raise its licensing standards and protect investors by ensuring that only well-capitalized, qualified market intermediaries receive a license, and to improve its monitoring of market intermediaries to ensure that they continue to meet licensing requirements;**

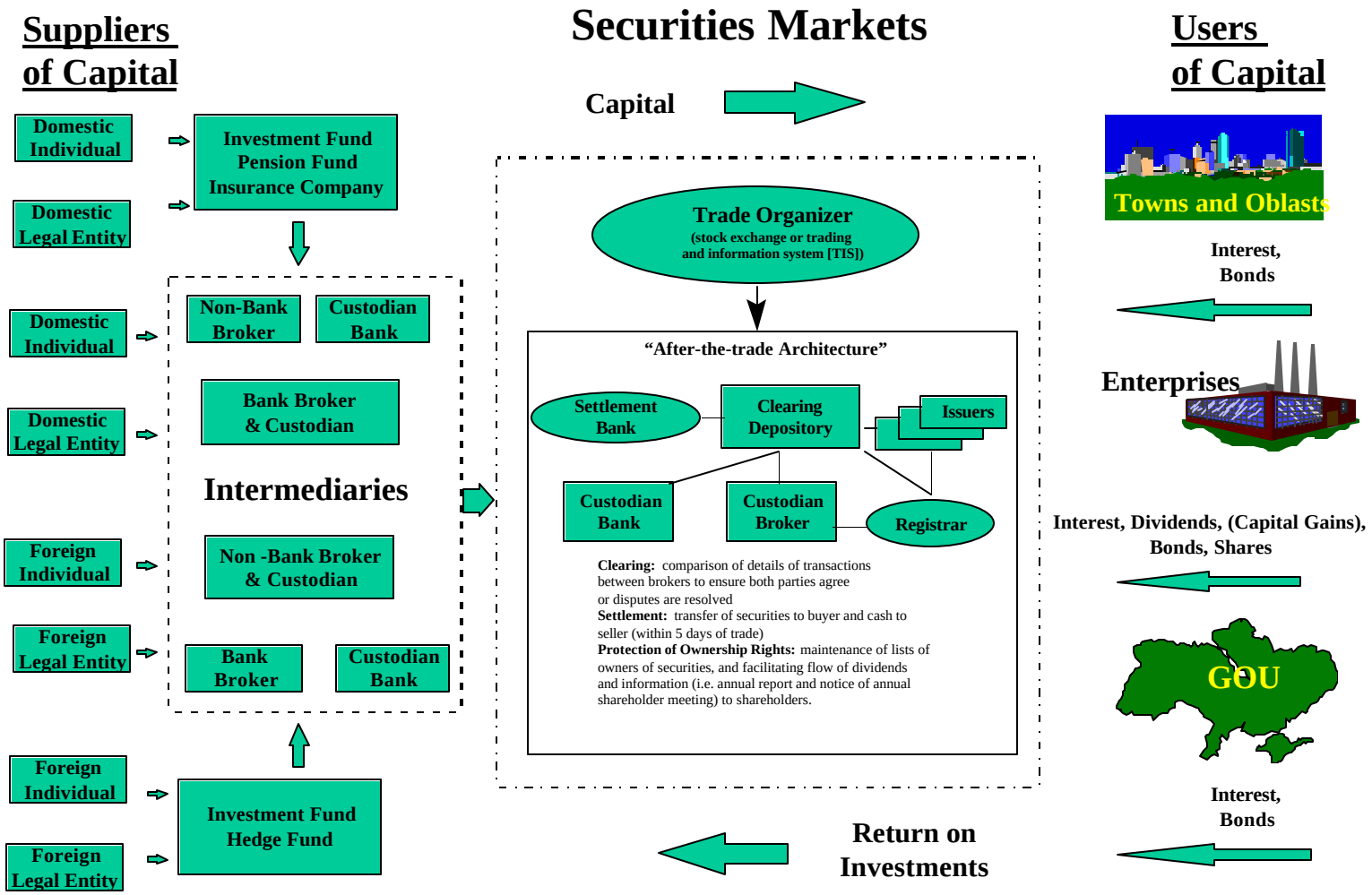
- **Amend the Law of Ukraine "On Entrepreneurship" to add the securities market activities to the list of licensed activities in Ukraine;**

- **Resolve the jurisdiction of Government agencies with respect to derivatives, ensuring that the SSMSC is the sole regulator for all types of futures contracts once true futures contracts develop in Ukraine; and**

- **Encourage the development of depository receipts on shares of Ukrainian issuers to increase foreign investors' demand for Ukrainian securities.**

Banking System




Suppliers of Capital
Securities Markets
Users of Capital
Capital
Domestic Individual
Domestic Legal Entity
Investment Fund
Pension Fund
Insurance Company
Domestic Individual
Domestic Legal Entity
Non-Bank Broker
Custodian Bank
Bank Broker & Custodian
Intermediaries
Foreign Individual
Foreign Legal Entity
Non -Bank Broker & Custodian
Bank Broker
Custodian Bank
Foreign Individual
Foreign Legal Entity
Investment Fund
Hedge Fund
Trade Organizer
(stock exchange or trading and information system [TIS])
"After-the-trade Architecture"
Settlement Bank
Clearing Depository
Issuers
Custodian Bank
Custodian Broker
Registrar
Clearing: comparison of details of transactions between brokers to ensure both parties agree or disputes are resolved
Settlement: transfer of securities to buyer and cash to seller (within 5 days of trade)
Protection of Ownership Rights: maintenance of lists of owners of securities, and facilitating flow of dividends and information (i.e. annual report and notice of annual shareholder meeting) to shareholders.
Towns and Oblasts
Interest, Bonds
Enterprises
Interest, Dividends, (Capital Gains), Bonds, Shares
GOU
Interest, Bonds
Return on Investments

5. The Government as Participant in the Financial Markets

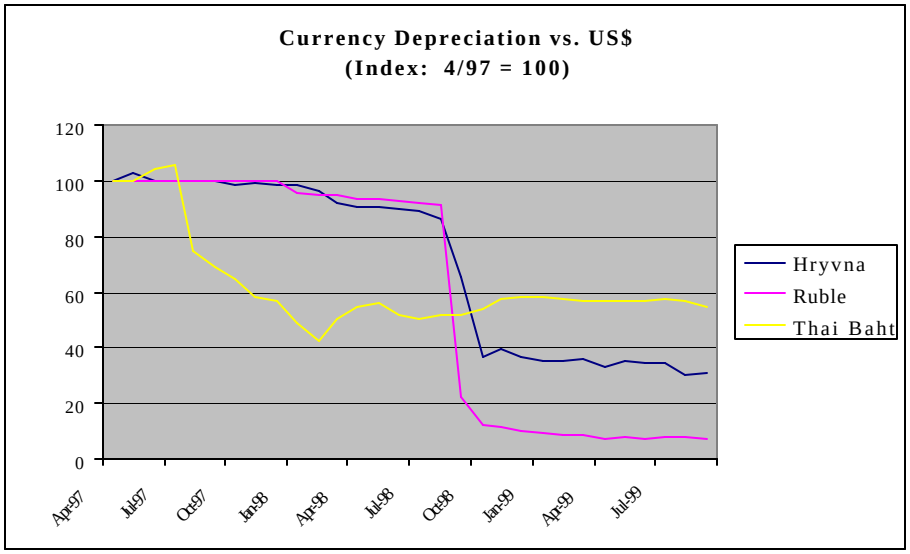
In addition to its role as lawmaker and regulator of the financial markets, the Government is also both a creditor and a borrower, both a shareholder and an issuer of shares. The Government acts as the largest borrower in the financial markets, is the largest holder of securities of Ukrainian companies, and is the largest seller of corporate securities. Therefore, any review of financial markets development in Ukraine requires a discussion of the Government's role as a participant in the market.

Government as Borrower – Funding the Deficit. Government borrowing has a significant effect on financial markets. Positively, when the Government borrows by issuing treasury bills and timely honors its repayment obligations, these securities can provide a low risk investment vehicle for banks, pension funds, investment funds, insurance companies and individual investors. Negatively, if the Government borrows a large share of the money available in an economy, there will be little or no money available to enterprises at reasonable interest rates to finance expansion and growth. This "crowding-out" effect is perhaps the most direct example of the *inter-linkages* between the Government's actions and financial markets development. The supply of capital is limited, particularly in a transition economy where money is too often fleeing the country, and the Government as the dominate player can easily consume the available supply.

In Ukraine over the last several years a mismatch between tight monetary policy and lax fiscal policy has resulted in such a "crowding-out" or credit squeeze. Following prudent monetary policy, the National Bank of Ukraine (NBU) has sharply limited credit expansion, resulting in relative stability in terms of inflation and the exchange rate. But it is a false stability – based on tight monetary policy and an artificial exchange rate – because it has not been matched by fiscal discipline. The Government of Ukraine (GOU) has not imposed the necessary tough budget constraints. This "soft budget culture" has resulted in large annual deficits.[108] Consequently, the GOU's borrowing requirements have grown steadily, significantly exceeding total credit expansion in the banking system. Put another way, the GOU has borrowed most of the limited supply of money in the economy, and in doing so driven interest rates up to unrealistically high levels, resulting in a shortage of credit

[108] According to Ukraine's official figures, budget deficits have averaged between 6 and 12 percent of GDP since independence – two to four times the 3 percent maximum set by the Maastricht Treaty for EU countries. Even the 3 percent EU limit is probably high for a country such as Ukraine because the EU limit is calculated for economies that are growing and generating increasing revenues that can be used to repay loans taken out to finance the deficit. Moreover, Ukraine's official figures greatly understate the actual magnitude of the deficit because they do not take into account the accumulation of arrears at the beginning of the 1990s, nor do they reflect the quasi-fiscal deficits represented by loans that the Government directed the banking system to extend to enterprises (instead of extending subsidies from the budget). Including such quasi-fiscal operations, the deficit has been estimated at up to 33 percent of GDP, 11 times the EU limit. (World Bank April 1999, 1-2; 1993, vol. 1, p. 4;).

for the productive sector.[109] Ukrainian enterprises simply cannot obtain the capital needed to modernize and expand.[110]



The dynamics of the situation changed somewhat in 1999. At the end of 1998, the GOU restructured treasury bill payments by "voluntarily" extending maturity dates, and the NBU stopped maintaining the Hrivna at the then-existing artificial exchange rate, in a significant currency devaluation.[111] These two actions destroyed real returns (in dollars) on treasury bills, and, together with the Russian crisis, effectively killed the treasury bill market. But this did not mean that money was suddenly available for commercial lending to enterprises. Some of the money that was being invested in treasury bills simply left the country. Some money remains tied up in treasury bills which were restructured to longer maturities and not redeemed. Further, the NBU announced, in a September 1999 telegram, that it would delay refinancing commercial banks "until further notice." At the same time, the Hrivna lost its value and monetary reserve and hard currency (Euro) capital requirements for banks were raised. Thus, banks today have significantly less free Hrivna resources, above capital and reserve requirements, available to lend.[112] An even more important

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[109] Treasury bills offered yields in excess of 70 percent in the summer of 1998, creating a powerful incentive for banks and investors to invest in these seemingly risk-free instruments rather than lending money at lower rates to riskier enterprises. (although banks and other investors should have recognized that there was a reason for a 70 percent yield and proceeded cautiously, if at all.)

[110] There are other reasons why enterprises cannot obtain needed capital, of course, including citizens' reluctance to use banks, and banks' reluctance to loan to enterprises. These reasons are discussed in detail in Chapter Three and more generally throughout this Paper.

[111] Although returns in Hrivna on some treasury bills remain positive, real returns in dollars are quite negative. This is a problem because banks are evaluated in dollar terms and their capital requirements are expressed in Euros. On October 1, 1998, the voluntary debt restructuring was declared an effective default by Standard & Poor's.

[112] The minimum statutory capital requirement was raised from one to three million Euros. Thus, some smaller banks stopped making loans because they fell below capital requirements. The change had a "chilling effect" on some other banks as well. In addition, monetary reserve requirements were raised from 15 to 17 percent (i.e., banks are required to keep an amount equal to 17 percent of each

factor may be that banks have no adequate risk monitoring systems in place, have no way to gauge the risks associated with lending to enterprises, and are simply unprepared to shift from investing only in treasury bills to operating as true commercial banks making loans to enterprises.

Ukraine has the lowest ratio of bank credit to the private sector of any transition country other than the Kyrgyz Republic: barely 2 percent of GDP. In other countries at Ukraine's income level, the ratio is about 20 percent, and for transition economies in general, the ratio is about 40 percent. Not surprisingly, commercial bank credit to enterprises is among the most expensive in the world. Real annual interest rates on (greater than three month) commercial bank loans were approximately 100 percent in September 1998. As of mid-November 1999, rates for such loans had improved for borrowers, but were still at an approximately 80 percent rate.

Government as Shareholder – Funding the Deficit. The Government also participates in the capital markets as the largest shareholder, with the State Property Fund (SPF) holding share packages in many large joint stock companies. Ironically, here too Government deficit spending results in less money available to enterprises because the SPF is instructed to vote at general shareholder meetings for large dividend payments to raise money for the budget. While this Paper focuses on sources of capital external to an enterprise – capital from the securities markets and the banking sector – it is important to keep in mind that the dominant source of enterprise finance in all developed market economies is retained earnings. This is true whether the economies are banking-based, like Japan and Germany, or market-based, like England and the United States. Retained earnings account for 70 to 100 percent of enterprise finance in these countries (Figure 5.1). Many "growth companies" in the West pay no dividends at all, choosing to reinvest all profits back into the company for capital expenditures and expansion. In a sense all Ukrainian companies are, or should be, "growth" companies, given the current situation. They should be reinvesting profits in modernization and expansion. Thus, pressure from the GOU to increase dividend payments reduces a key source of financing that is available to, and important for, companies in other countries of the same type (growth) as those in Ukraine.[113]

State ownership also tends to restrict enterprises' ability to raise money by issuing shares. The SPF is likely to block any new share issuance because it will not have the means to purchase a proportional amount of the newly-issued shares and thereby retain its percentage ownership of the company.[114]

In sum, the Government's budget deficit plays a role in blocking economic growth and expansion by tending to restrict the three sources of capital potentially available to enterprises – retained earnings, external credit, and equity financing.

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liability on their books on deposit in Hrivna with the NBU, in a non-interest bearing account). The change from 15 to 17 percent was small, but also contributed to reducing the money available for lending by banks of all sizes. On top of this, the currency devaluation eroded banks' capital in real, hard currency terms. The currency devaluation also meant that banks needed to dedicate more Hrivna to meeting monetary reserve requirements on hard currency deposits (i.e., banks needed to borrow or otherwise obtain more Hrivna, after the currency devaluation, to meet the monetary reserve requirement on a given dollar-denominated liability).

[113] Of course, to the extent that managers are actively engaged in corporate governance abuses, leaving more money with the company will only exacerbate these abuses.

[114] Share issuances are also blocked by the privatization legislation "during the plan of privatization."

Figure 5.1

Sources of net corporate financing, 1970 - 1989 *
(percent of net investment financing, excluding accumulation in financial assets)

	Germany	Japan	United Kingdom	United States
Internal	81	69	97	91
Bank	11	31	20	16
Bonds	-1	5	4	17
Shares	1	4	-10	-9
Trade credit	-2	-8	-1	-4
Other	10	0	-8	-13

* Net equity (shares) emissions were negative in the US and UK during this period because managers and "corporate raiders" replaced shares with bank and corporate debt - a process known as a leveraged buyout (LBO).

Source: Corbett and Jenkins, 1994

Reasons for the Deficit. It appears that fear of widespread unemployment (if failing enterprises are not supported) is one of the main reasons for Ukraine's excessive deficit spending. Ukraine is currently encumbered with inefficient, unprofitable enterprises, and the Government feels compelled to support these enterprises in order to avoid job losses, even at the expense of running budget deficits. The primary reasons for the poor state of these enterprises are well known: historical isolation from Western competition; energy inefficient industries; large-scale enterprises with too many workers; over-priced production inputs; and a lack of capital.

A History of Supporting Failing Enterprises. While the methods have changed over time, the GOU continues to support the country's failing enterprises. Between 1992 and 1994, the GOU subsidized such enterprises with directed credits from the banking system. With the growth of banking credit, the money supply peaked at more than 1,000 percent in 1993, resulting in devastating hyperinflation. During 1994-95, the GOU stopped printing money to support failing enterprises and instead increased direct subsidies to enterprises from the budget. During 1994, these subsidies reached 34 percent of total spending, pushing the budget deficit to 9 percent of GDP. The situation has improved somewhat, in part because the GOU does not have budgetary funds to continue subsidies, but the GOU is now allowing failing enterprises to "pay" their taxes in barter or with veksels and offering them various tax privileges (waivers or deferred payments of taxes and write-offs of budget loans and tax debts) and State guarantees for loans. This is particularly true in industries deemed strategic, such as coal mining. All of these methods drain the budget and contribute to a chronic shortage of funds available to promising enterprises.

> Markets with free entry are like contests: profits depend on performance. Governments that create protective walls around an industry remove this discipline and shut off the information flow that markets sustain.

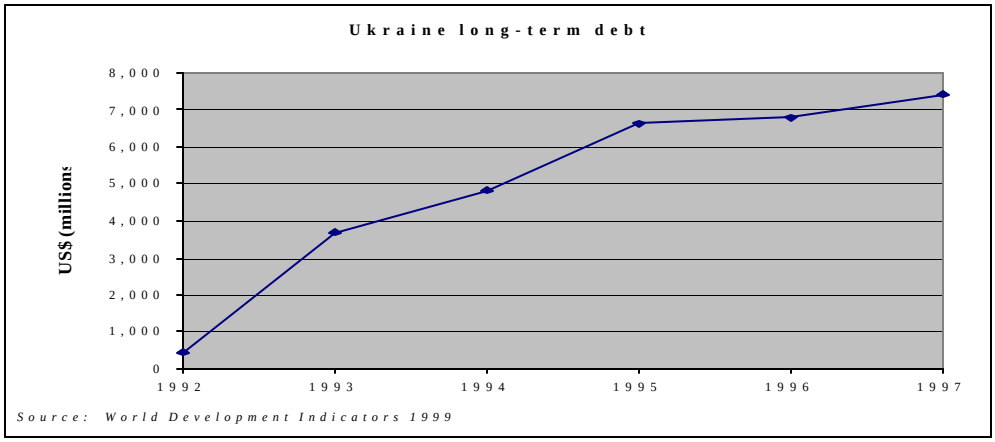
Further Problems Caused by Continued Support for Failing Enterprises. In addition to continued support for failing enterprises resulting in a lack of capital available to promising enterprises, other problems have resulted:

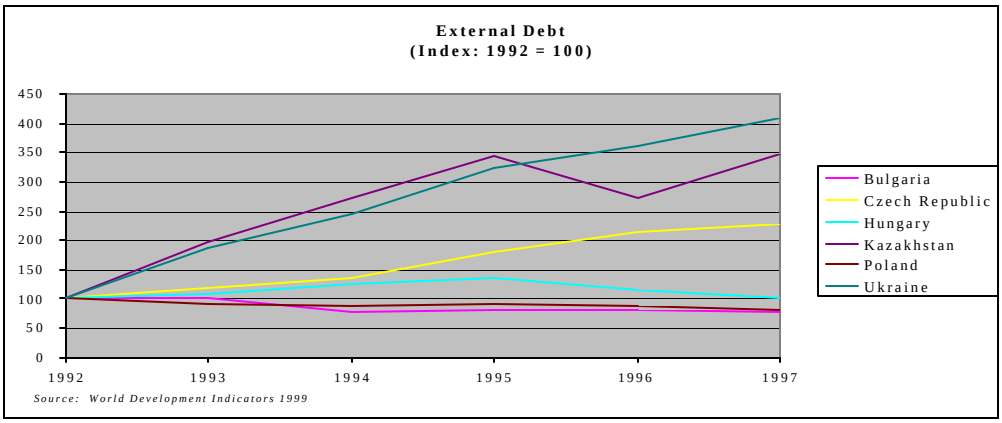
- A debt crisis and investor fear of default;
- An increased tax burden;

- Increased corruption;
- A lack of incentives for enterprises to restructure and reform; and
- Competition between businesses on the basis of political connections.

1. The Debt Crisis and Investor Fear of Default: The debt owed by the GOU has been rising rapidly. This debt was secured on highly unfavorable terms – short maturities with high interest rates – forcing Ukraine to borrow ever increasing amounts of money to meet its debt obligations. Ukraine now faces an ominous bunching of debt maturities in 2000 - 2001. Officials have stated that Ukraine can meet its obligations through increased revenue from privatization.[115] Some officials have also spoken openly of trying to restructure Ukraine's foreign debt – although some debt, such as the outstanding Eurobonds, is held by a disparate group of investors with whom it would be difficult to reach agreement.

> *It's tough to make predictions, especially about the future.*
>
> Yogi Berra





[115] Speeding up privatization next year may be the "silver lining" of the debt crisis. The Verkhovna Rada generally opposes increased strategic privatization despite the need to raise money for the budget, but its ability to block privatization may have been weakened by the recent presidential elections. Ukraine has little room to maneuver. The country must pay more than Hr 15 billion ($3 billion) in foreign debts in 2000, while the NBU had just Hr 5.55 billion ($1.11 billion) in hard-currency reserves as of November 24, 1999 (Interfax). The biggest challenge will come in the first quarter of 2000, because on March 17 Ukraine is required to repay Hr 2.7 billion ($540 million) in Eurobonds. To date, no sovereign Government has ever defaulted on Eurobonds.

Ukraine is working to create an improved, unified debt management system within the Ministry of Finance (MOF) that includes timely and reliable information sharing between the MOF, Ministry of Economy, and NBU. If the GOU in fact implements such a debt management system, and reforms and accelerates the privatization process, many analysts believe that default can be avoided. If this proves to be true over the course of the next two years, it will send a powerful signal to investors and lenders that the country is committed to reforms, helping to develop an atmosphere of *confident expectations* in Ukraine's financial markets and lowering the cost of borrowing.

2. An Increased Tax Burden: The policy of supporting failing enterprises has resulted in a higher tax burden on successful enterprises and on individuals, resulting in negative repercussions for the financial markets. Companies that pay taxes are penalized in order to subsidize those that do not pay. Taking capital from successful companies with real prospects for expansion and job creation and redirecting it to failing enterprises is hardly an efficient allocation of capital. The effect of tax policy on financial markets development is discussed more fully in Chapter Nine.

3. Increased Corruption: Much of the corruption in Ukraine is closely tied to the intricacies of GOU enterprise support programs. When low-paid civil servants can dispense valuable benefits to enterprises, the opportunities and temptations to engage in corruption are obvious.

4. A Lack of Incentives for Enterprises to Restructure and Reform: Restructuring of large enterprises fails to occur, in part, because of the GOU's policy of providing tax privileges and other protections. These enterprises remain inefficient because the pressure to reform is delayed by continuing Government support. Only fear of failure, the threat of bankruptcy and closure, will cause enterprises to restructure.[116] Terminated subsidies and consequent restructuring in Estonia and Hungary demonstrated this.

5. Political Rent Seeking and Competition between Businesses on the basis of Political Connections: Continued support has resulted in distorted competitive conditions. Too often, companies compete on the basis of political connections rather than on costs, quality and price. Managers spend considerable time in Kyiv lobbying the Cabinet of Ministers (COM), branch ministries, and the Verkhovna Rada for valuable State benefits – tax breaks, access to cheap land and energy, and freedom from bureaucratic harassment. Efforts to win the "lottery" for privileges divert managers from the daily work of managing their enterprises to make them more competitive. Moreover, the distortions in the system mean that the least productive companies can come out the winners. The result is a bastardization of market economics.

Reducing the Deficit. The GOU should rapidly phase out all of the various direct and indirect supports for failing enterprises, including tax privileges, access to cheap land and energy, and State guarantees for loans. The GOU needs to move

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[116] By "restructure," we mean that enterprises will seek out new markets; find new investment partners, domestic and foreign; implement new production technologies, and new management methods; develop new designs and products; improve marketing and sales skills; improve quality control; implement more effective worker and management incentives; and adjust staffing levels to match production requirements. Enterprises will also lease or sell unused or underutilized buildings, equipment and land, thus paving the way for the creation of new enterprises that can employee workers laid off in the restructuring.

from a Soviet approach to economic management, where the Government is directly responsible for enterprises, to a market approach, where enterprises are the responsibility of private owners. Fears of massive unemployment and social unrest if supports are removed are unfounded.[117] The recent history of Poland illustrates that as inefficient jobs are lost, new jobs are created. Further, in realistic, relative terms, the current policy is causing more problems than would be caused by whatever unemployment would result from imposing hard budget constraints.

Increased privatization is also imperative. Among the many other benefits of privatization, proceeds from privatization will help balance the budget, and the State will no longer feel the need to support these enterprises.

The GOU should follow a "hard budget constraint" and maintain expenditures consistent with revenues and debt service obligations; allow the exchange rate to balance the demand and supply for foreign exchange; and, follow a middle path between excessively tight and excessively loose monetary policy. Further, the specific International Monetary Fund (IMF) and World Bank recommendations regarding debt and budget formulations should be implemented.

Institutional Investor's 1999 Country Credit Ratings	**Scale = 1 - 100**
Czech Republic	59.1
Poland	57.5
Hungary	57.3
Estonia	45.9
Global average rating	41.5
Slovakia	41.5
Latvia	40.8
Croatia	39.6
Lithuania	38.3
Bulgaria	30.3
Kazakhstan	29.7
Romania	28.7
Russia	19.3
Uzbekistan	18.9
Ukraine	18.7
Belarus	13.4
Georgia	10.8

Respondents lowered ratings for only five East European countries: the Czech Republic, Georgia, Romania, Russia and war-ravaged Yugoslavia. And despite the continuing woes of neighboring Russia - which caused one banker to describe the nation as a "risk case unto itself" - the former Soviet Republics of Belarus, Kazakhstan, Ukraine and Uzbekistan all saw their ratings improve.

Source: Institutional Investor, September 1999

Local and Regional Government Bonds. Once the pride of Ukraine, local and regional public infrastructure is now in a state of decay. Bond offerings by local and regional Governments (oblast, rayon, municipality, city and settlement) (hereinafter

[117] An in-depth study recently completed in Russia lends evidence to this assertion. The McKinsey Global Institute just completed a year long study of many of Russia's key industries. To take one example, the study concluded that if Russia cut off the subsidies that steel mills receive in the form of low cost or free power, the natural evolution of the local economies in most areas would create enough jobs in the service sector to redeploy workers laid off when uneconomic steel plants are closed. Absent Government intervention, service industries such as food retailing could expand to absorb workers. We believe that the situation is generally similar in Ukraine.

"local Government bonds") can help raise funds to repair and replace this infrastructure.[118] Local Government bonds can also provide a relatively safe investment vehicle for individuals, investment funds and pension funds. But Ukraine cannot afford another fiasco like the 1998 Odesa bond issuance. Such failures significantly harm efforts to build a climate of *confident expectations* in Ukraine's financial markets. Unfortunately, the heightened uncertainty caused by such a failure is not confined to the narrow local Government bond market. From the standpoint of investor psychology, the various sub-markets within Ukraine's overall financial markets are all inevitably *interlinked.* The Odesa default is viewed as fresh evidence that Ukraine is not a safe place to invest or loan money, raising the cost of capital throughout the financial system.

The first local Government bond offering in modern Ukraine was a "barter bond" issued by the city of Cherkassy on February 1, 1995, to finance housing construction. At least 25 other local Government bond issues have been attempted since, although only six have been fully subscribed and another five were subscribed at levels from 25 to 75 percent. Some offerings have yielded principal and interest in cash; others have yielded the equivalent of principal and interest in commodities or housing ("barter bonds"). The proceeds of some offerings were used for specific projects; the proceeds of others were loaned to banks at a higher rate of return – a form of arbitrage that takes advantage of local Governments' ability to raise lower cost funds. Purchasers have included Ukrainian individuals and financial institutions, and, in the case of the Odesa bond offering, foreign institutional investors. The failure of the Odesa issuance in 1998, combined with new requirements for MOF approval of local Government bond offerings, has put a temporary halt to the development of this market.

> *Good judgment comes from experience. Experience comes from bad judgment.*
>
> Walter Wriston

Policymakers should continue to work to revive this potentially important segment of the financial markets while implementing institutional reforms to prevent a repeat of the Odesa fiasco. Encouragingly, the COM, MOF, Securities and Stock Market State Commission (SSMSC) and local and regional Governments have been working on some of the needed changes, including instituting a new regulatory regime in which MOF review will be required to determine if local Governments' plans meet rigorous credit standards and SSMSC review will be required to ensure that offering prospectuses contain full and accurate disclosure of information to investors. This is a reasonable split of responsibility between these two agencies, and these efforts should be encouraged. SSMSC Resolution No. 91, dated July 28, 1998, and MOF Order No. 19, dated January 19, 1999, represent important steps toward improving the regulatory framework.[119] The task now is to ensure that these

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[118] This section of the Paper discusses bond offerings by local and regional Governments, but many of the points raised also apply to debt financing by communal service enterprises (e.g., water, solid waste, heating, transportation, electricity and gas distribution enterprises).

[119] SSMSC Resolution No. 91, regarding placement within Ukraine of local Government bonds, requires: i) that the amount of funds planned to be raised through a bond offering be specified by the issuer during adoption of the budget for the relevant year and submitted for approval by the MOF; ii) that the resolution of the local Government on adoption of the budget be submitted to the SSMSC; iii) that the bond offering prospectus include the amount of the issuer's budgeted revenue and expenditure, and the amount of the budget surplus or deficit for the last two years; iv) that, after the end of the placement period, an issuer not cancel the bond offering; and, v) that an issuer report monthly to the SSMSC during the placement period on the progress of the placement, and during the redemption period on the progress of redemption.

regulatory changes are implemented in practice, and to make additional needed changes, including:

Budgeting and Accounting

- Improve local Government budgeting and accounting in accordance with international accounting standards, including a clear division between current and capital budgets and better task-based (program) budgeting;
- Prohibit the use of bond proceeds to finance arrears by local Governments, and enact tight constraints on the use of such proceeds for cash flow financing. This is necessary to avoid local Governments creating a "debt trap" – a continually growing pyramid of debt – as has occurred at the national level;
- Clarify the division of taxation and expenditure responsibilities between the national and local levels of Government, putting all inter-Governmental transfers on a transparent, rational, and formula-driven basis, and ending the practice of "negotiated" inter-Governmental transfers. Local Governments must have predictable responsibilities and adequate revenues to fulfill those responsibilities;
- Increase the capacity for local Governments to run their finances independently, autonomously raise revenue, and deliver purely local services in an efficient manner;
- Increase incentives for local Governments to take measures that increase revenues or reduce costs (such measures now result in a reduction in funds from the national Government the following year – a system of "confiscatory budgets");

Auditing and Disclosure

- Require periodic disclosure (monthly or quarterly) from local Government issuers describing the financial position of the issuer and the repayment status of all outstanding debts;
- Require independent audits of local Governments seeking to issue bonds. This is expensive, but necessary to provide investors with the information necessary for an informed decision. Audits by the national Control-Inspection Service are insufficient as they tend to focus on exposing wrongdoing rather than providing regular financial information to investors and Government decision-makers;

Training

- Train local Government professionals to prepare and present capital investment projects and financing plans in a rigorous fashion, and to use standardized, competitive procurement processes to ensure that projects are completed as cost-efficiently as possible;

MOF Order No. 19 requires: i) that the MOF, before the beginning of each budget year, approve the amount of internal borrowing (borrowing within Ukraine) to be conducted by each local Government; ii) that the total amount of internal borrowing of all local Governments not exceed an overall ceiling to be determined by the MOF; iii) that the maximum amount of internal borrowing of a local Government not exceed fifteen percent of the planned amount of budget revenues for the year, after deduction of subsidies from the State budget and credits from banks; iv) that the expenses associated with servicing and redeeming the debt from internal borrowings of a local Government not exceed fifteen percent of the planned amount of budget expenditures for the year; and v) that documents be submitted to the MOF for approval by December 10 of the year preceding the planned year, detailing the amount to be borrowed, the planned use of proceeds, and the plan for repayment of the debt. External borrowing (borrowing from sources outside of Ukraine) by local Governments is prohibited until completion of a MOF regulation on external borrowing.

Government Regulation

- Clarify that the national Government will not "bail-out" local Governments that default on their debt. It must be clear that local Government debt issues have neither the explicit nor implicit guarantee of the State. This will help develop the necessary "hard credit culture" – a shared expectation that the borrower will repay principal and interest on time and with a high degree of certainty;

Protections in case of Default

- Improve the ability of local Government bondholders to create and enforce security interests in assets pledged as collateral. The legal provisions are mostly in place to allow local Governments to pledge cash flows, securities, and physical assets such as land, buildings and equipment, but there is little history of judicial enforcement;
- Develop mechanisms to facilitate collective action by bondholders in the event of a default. Ukraine does not have "class actions," where many plaintiffs can be joined in one lawsuit. Unless and until a "class action" mechanism can be developed, there must be one entity, such as a trustee, who can sue and recover on behalf of all bondholders; and
- Ensure that there are clear negative consequences for local Governments that fail to pay creditors, through a functioning "work-out" system. This would likely require a new law (or additions to an existing law) on local Government bankruptcy.

The local Government bond market can be restarted. For now, offerings should be tied to specific projects with strong revenue streams that can be dedicated to the repayment of the debt. With work this market can become a valuable part of the financial markets in Ukraine.

Action Points:

- **Work to reduce the deficit so that Government requirements for capital do not (as is the case currently) have the effect of restricting the capital available to productive enterprises;**

- **End the practice of Government direct and indirect support for failing enterprises. Such support currently takes the form of access to cheap land and energy and allowing such enterprises to "pay" their taxes in barter or with veksels and offering them various tax privileges (waivers or deferred payments of taxes and write-offs of budget loans and tax debts) and State guarantees for loans;**

- **Swiftly complete creation of an improved, unified debt management system within the Ministry of Finance (MOF) that includes timely and reliable information sharing between the MOF, Ministry of Economy, and National Bank of Ukraine (NBU);**

- **Impose a "hard budget constraint" on the Government and maintain expenditures consistent with revenues and debt service obligations; ****

- **Allow the exchange rate to balance the demand and supply for foreign exchange; ****

- **Follow a middle path between excessively tight and excessively loose monetary policy; and ****

- **Work to revive the market for local and regional government bonds while implementing institutional reforms to prevent a repeat of the Odesa fiasco. Ensure that the regulatory changes recently adopted by the Securities and Stock Market State Commission (SSMSC) and MOF are implemented in practice, and make additional needed changes as outlined in this Chapter.**

** These are general guidelines. The specific International Monetary Fund (IMF) and World Bank recommendations regarding debt and budget formulations should be implemented.

6. Collective Investment Institutions and Pension Reform

Collective investment institutions (investment funds, private pension funds, insurance companies, and other institutions that pool savings) can play a major role in enhancing economic growth, assisting financial markets development, and bolstering retirement living standards.[120] In mature economies, with well developed legal and operational structures, collective investment institutions accomplish the following:

- create pools of capital for investment in debt and equity instruments, fueling economic growth and job creation;
- attract investors into the market by allowing them to diversify risk and providing them the benefit of professional asset management;
- increase market efficiency by compelling issuers to provide detailed information on a cost effective basis; and
- play an important role in corporate governance by monitoring, and in some cases replacing, management at the portfolio company level, and by insisting on corporate restructuring.

However, in transition economies such as Ukraine's, agglomerating capital pools and gaining the benefits they provide is jeopardized by several key factors:

1. *Theft and fraud*: fear that corruption will lead to stolen assets;

2. *Risk of domestic markets*: fear that domestic government bonds and/or domestic shares will be mandated as the sole or dominant permissible asset classes for investment, thus allowing only high risk investing;[121]

3. *Operational and legal infrastructure weakness*: fear that inexperienced custodians, investment advisers and management companies, coupled with inadequate legal safeguards and regulatory oversight, will threaten routine operations.

In short, while collective investment institutions can potentially offer a nation considerable benefits, this will only happen if fraud, risk management, and operational issues have been successfully addressed. This Chapter discusses current and recommended initiatives in Ukraine to address these three central impediments to successful development of collective investment institutions.

Ukrainian Investment Companies and Funds. Currently operating investment companies and funds, organized pursuant to the 1994 Presidential Decree "On Investment Funds and Investment Companies," have been active in the privatization process by collecting privatization certificates from citizens and investing them at enterprise auctions. As of September 1, 1999, approximately 137 investment funds and 109 investment companies were operational. Problems abound with these

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[120] There are significant commonalities among investment funds, private pension funds, and insurance companies: they all involve managing pooled assets on behalf of others, which gives rise to "fiduciary duties." See footnote 47. This Paper uses the term "private pension funds" to refer to pillar two and pillar three funds.

[121] The average retail investor, whether in France, Germany, Brazil or Ukraine, would never voluntarily invest more than a tiny fraction of his total portfolio in an emerging market such as Ukraine's. Instead, he would diversify his investments across many countries, with the bulk of his assets invested in more predictable, mature markets where the risks are lower.

investment companies and funds. Many such funds are simply vehicles for fund managers or large foreign investors to accumulate large blocks of shares.[122] Moreover, through various schemes, certain unscrupulous fund managers have converted the value of assets in the funds to themselves at the expense of investors. These activities (following earlier scandals with trust companies) have significantly undermined public confidence in collective investment institutions. Problems are exacerbated by the lack of specific provisions to protect investors in the 1994 presidential decree.

In addition, most existing closed-end funds have sunset provisions that require their liquidation in 1999 or 2000. When these funds were created, it was anticipated that the market for shares would be liquid by the time the funds were to terminate operations. Unfortunately, no such liquidity has developed and it is likely that, even if the funds hold potentially valuable shares, no value will accrue to investors because of the limited time-frame for liquidation. Moreover, the dumping of so many shares on the market at the same time might negatively impact what little liquidity there is, driving prices down further.

Considering that the existing funds are tied to the certificate privatization process, which has now ended, and that their investment portfolios are largely non-diversified and illiquid, privatization funds need to be separately administered (i.e., liquidated or reorganized), subject to a separate legal regime from new funds.[123] Simultaneously, a workable legal framework for new investment funds, involving sound fiduciary principles and international best practices, should be developed.

A Law for Investment Funds. Ukraine needs a legal and regulatory structure to permit *open-end investment funds* to develop.[124] The Securities and Stock Market State Commission (SSMSC) has drafted a law "On Collective Investment Institutions (Unit and Corporate Investment Funds),"[125] which passed its first reading in

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[122] Some investment funds purchased shares of enterprises at certificate auctions pursuant to the instructions of the enterprise director. The shares were then sold cheaply to the director, or kept in the fund's portfolio but voted pursuant to the director's instructions. The enterprise director might pay a "consulting fee" to the fund manager to ensure his cooperation. In addition, a number of funds purchased shares on behalf of foreign investors, who were not permitted to participate directly in privatization certificate auctions. These funds often have no small investors today, because the large foreign investor financed the redemption of investment certificates from the fund's investors long ago (generally at higher prices than those investors would receive if they remained invested in the fund in the current depressed market). Thus, these funds are essentially shells waiting to be liquidated so that the foreign investor can acquire the enterprise shares directly.

[123] The Securities and Stock Market State Commission (SSMSC) and the State Property Fund (SPF) are attempting to develop an orderly procedure for liquidating these privatization funds or reorganizing them into open-end funds.

[124] An "open-end" fund is required (daily or periodically) to redeem investors' shares at the fund's "net asset value." Investors in a "closed-end fund" may exit the investment prior to the fund's liquidation only by selling their shares to another investor. Securities markets must be at least moderately liquid before open-end funds are realistic because open-end funds must be able quickly to sell portfolio securities and raise cash to meet redemption requests. Open-end funds, however, are generally preferred over closed-end funds because investors can exit the investment if they are dissatisfied with the fund's performance.

[125] The draft law uses the terminology *corporate investment fund* to refer to a fund organized as a legal entity ("investment company") and *unit investment fund* to refer to a non-legal entity fund ("unit

September 1999. This law, which would establish a legal framework for collective investment activity including open-end funds, is an important first step towards creating an environment of *confident expectations* that over time may convince Ukrainians to entrust their savings to investment funds, putting this money to productive use.

Every effort should be made to finalize this draft law – consistent with the principles outlined below – and pass it as soon as possible. Moreover, a unified conceptual approach should be taken with all forms of collective investment – investment funds, pension funds and insurance company products – so that their common features (management, custody of assets, conflicts of interest, distribution) may be consistently regulated.[126]

The following key principles are lacking or under-developed in the draft law and must be expanded and reflected therein:

- separation of investors' assets from assets of the management company;
- strict regulation and oversight of management companies;
- required training of a new category of market professionals – "investment advisers" – to manage a fund's securities portfolio;
- establishment of asset composition guidelines; and
- the SSMSC's role in regulating investment fund activities and making information publicly available.

1. Separation of investors' assets from assets of management companies: Investors' assets should be maintained in a legal entity *separate* from the management company, not just in a special current account of the management company.[127] This is necessary to protect assets and allow assets to be easily transferred to another management company in the event that the first management company becomes insolvent. This separate legal entity could take the form of a specialized type of joint stock company, in the case of a corporate investment fund, or a non-commercial organization, in the case of a unit investment fund.

2. Strict regulation and oversight of management companies: Legal protections to guard against misuse of funds by management companies are crucial. Of particular importance are restrictions on transactions between the fund and entities *affiliated* with the management company or its personnel, as such transactions present a conflict of interest and often are a way for managers to steal value from investors. Rules governing affiliated transactions should be clear and simple and the penalties for violations severe – severe penalties help to balance the fact that violations may be difficult to detect.

Oversight of management companies by a fund's supervisory board is also important. The supervisory board should play a significant role in monitoring the activities of the management company to ensure compliance with the fund's

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trust"). In this Paper, we use the term "investment fund" generically to refer to both types, unless the context requires a specific reference to one or the other type.

[126] The SSMSC is actively working on these issues together with the Verkhovna Rada.

[127] This recommendation would require a significant change to the version of the draft law that passed its first reading. That draft envisioned that assets invested in unit investment funds would be kept in a special current account of the management company. We recommend instead that those assets be maintained in a legally independent non-commercial organization. Several draft laws on non-commercial organizations are now under consideration in the Verkhovna Rada.

investment declaration. This should be detailed in the law, and members of fund supervisory boards should be trained in how to fulfill their duties.

Further, custodians should be given supervisory responsibilities vis-à-vis management companies. In a transition economy where other safeguards are weak, it is important that the custodian be given an elevated "watch dog" role to monitor the management company and report any irregularities to the SSMSC, with stiff penalties for failure to do so.[128]

3. Training of a new category of market professionals – "investment advisers" – to manage a fund's securities portfolio: An "investment adviser" license should be required in order provide securities investment advice to an investment fund or private pension fund.[129] This activity should be a separately licensed, exclusive activity performed by a legal entity regulated by the SSMSC.[130] Further, a group of investment advisers with the skills and experience necessary to manage a portfolio of securities needs to be developed in order to attract capital to the market. With input from the donor community and cooperation of the SSMSC, an investment adviser training program should be developed to accomplish this important task.

4. Asset composition rules: Open-end investment funds must maintain liquidity in order to be able to raise cash to meet redemption requests. Therefore, open-end funds should limit their holdings in illiquid assets generally to a maximum of 10 percent of the portfolio. Closed-end or specialized funds may be permitted to invest a higher percentage of their holdings in less liquid or higher risk instruments (subject to particularly extensive disclosure requirements). All funds must be required to disclose to investors the risks of the fund's chosen asset mix. A fund's management company should demonstrate expertise in the chosen type of investment activity. As a general matter, in the initial period the SSMSC should have the authority to establish guidelines for (and restrictions on) each type of fund's portfolio investments, and to update those guidelines on a regular basis to keep up with changes in the market. Investments in international bonds and stocks should be encouraged.

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[128] We note that it should not be necessary to establish any special licensing requirements for the fund custodian. A single license should be adequate for all custodian activity, whether it be holding assets for the customer of a securities trader, holding assets in Ukraine for a global custodian abroad, or holding assets for domestic collective investment institutions. In addition, further efficiencies could be achieved – with no increased risk to investors – if the custodian internalized the activity of maintaining the register of fund participants, rather than requiring a fund to retain a separate registrar.

[129] There are a total of three new licensed activities envisioned in the proposed scheme of collective investment regulation: i) investment adviser; ii) investment fund management company; and iii) pension fund management company (Figure 6.1 and Figure 6.2). An investment fund management company would be licensed by the SSMSC, while a pension fund management company would be licensed by a State pension inspectorate or similar agency (Figure 6.3 and Figure 6.4). If the management company does not hire an external investment adviser, then the management company would be required to obtain an investment advisory license from the SSMSC. These three licensed activities should be added to the list of such activities in the law "On Entrepreneurship," which is supposed to contain the complete list of licensed activities in Ukraine.

[130] If closed-end funds are permitted to invest in real estate, precious metals or other non-securities investments, policymakers need to consider whether management of these types of assets will be performed by "investment advisers" licensed by the SSMSC, or by some other category of licensed market professionals.

Figure 6.1
Model organizational structure for investment funds

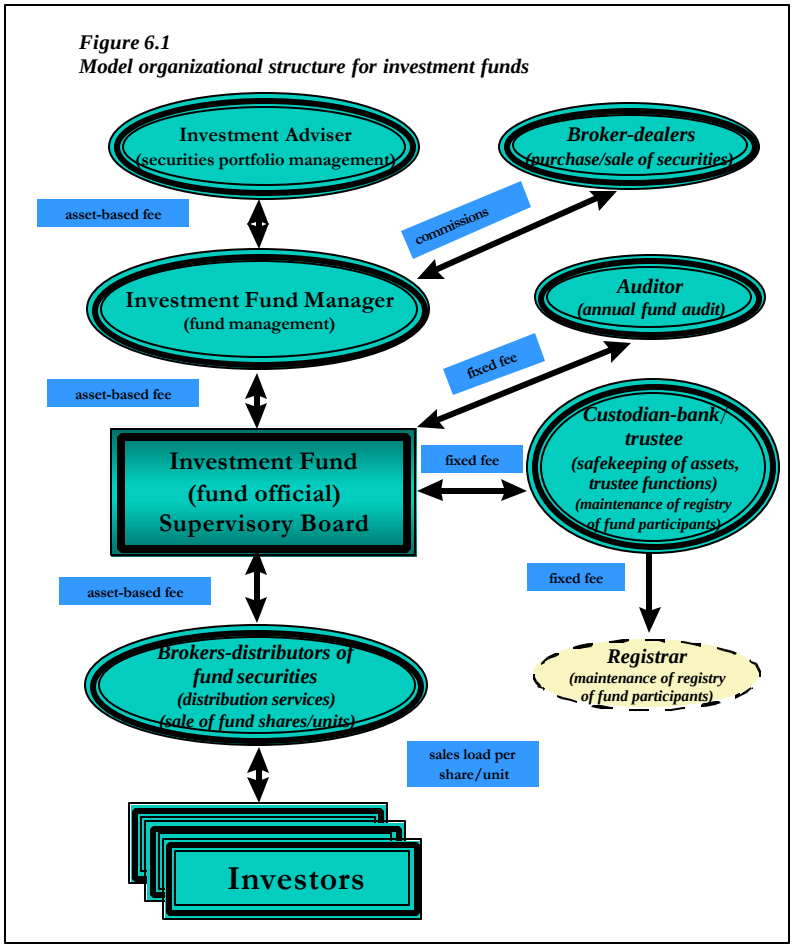


Figure 6.2
Model organizational structure for private pension funds

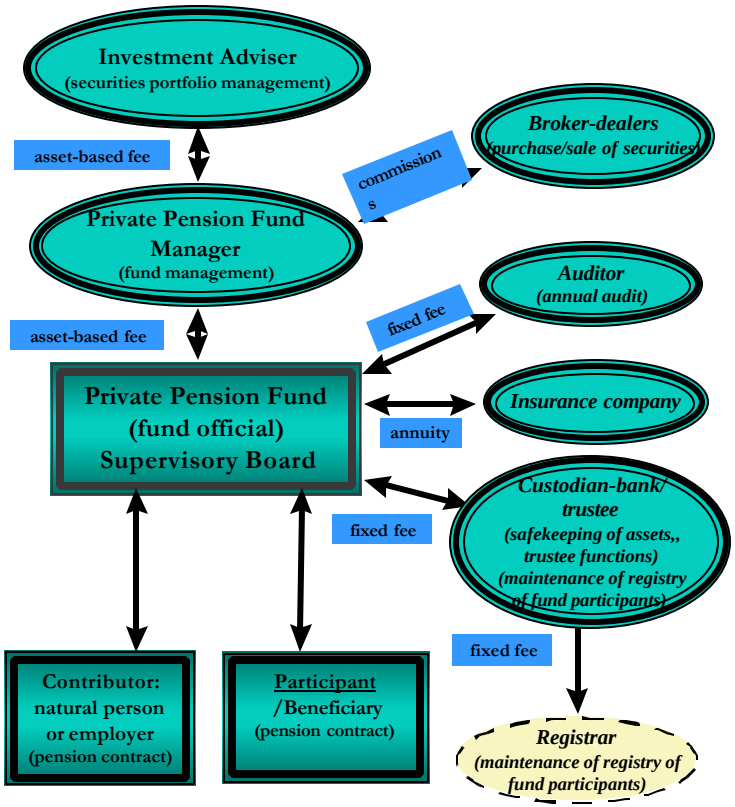


Figure 6.3
Oversight and reporting: investment funds

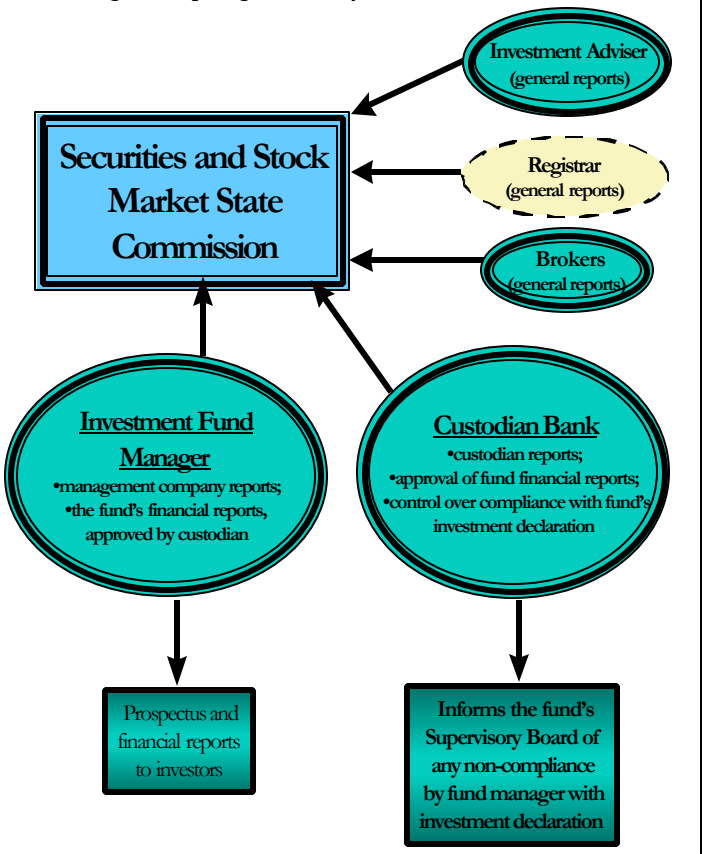
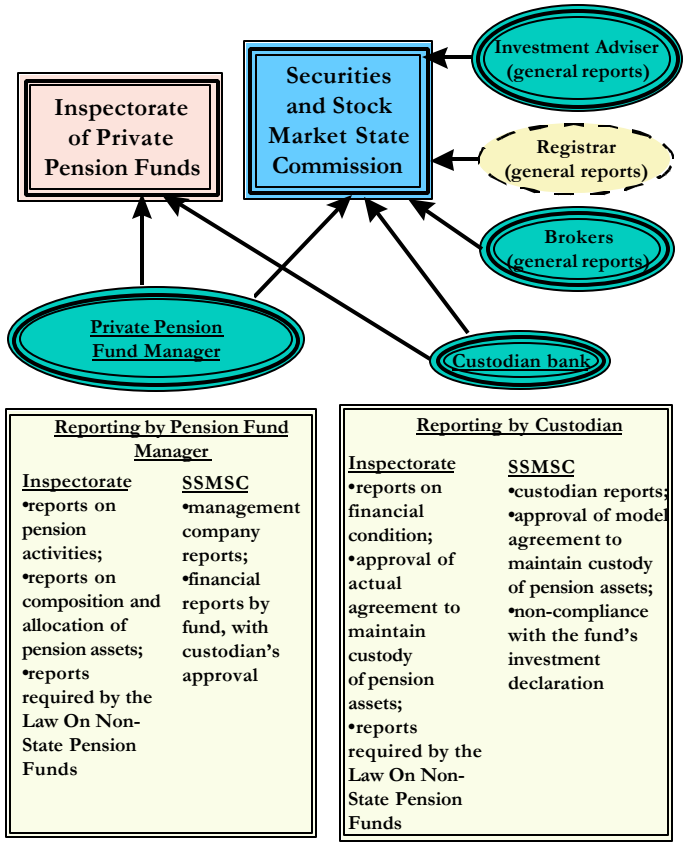


Figure 6.4
Oversight and reporting: private pension funds



5. The SSMSC's Role in Regulating Investment Fund Activities and Making Information Publicly Available: Regulatory oversight over the activities of investment funds and their management companies should be exercised by the SSMSC. Management companies should report to the SSMSC as to their own activities (financial condition, professional credentials, disciplinary history, etc.) and as to their investment fund activities (financial statements, performance, fees). These reports should then be made publicly available. Financial information concerning a fund should be substantiated by its custodian. In addition, investment funds should be audited annually, with the results submitted to the SSMSC and also made publicly available.

The Pension System in Ukraine. Ukraine, like many nations, is unable to meet existing pension obligations. This is common world-wide because pay-as-you-go (PAYG) systems are prevalent, and often are inadequate to meet the promised pension payments. In Ukraine, the pension system is facing major challenges, including:

- Low benefits;
- Widespread contribution evasion;
- A large number of retirees;
- Inefficient administration;
- An unpredictable and unreliable system;
- A financially unsound and unsustainable system; and
- Benefits paid almost without regard to work history.

1. Low Benefits: Ukraine does not provide adequate income for its retirees. The poverty level is about Hr 118 ($23) per month while average pension benefits are about Hr 66 ($13) per month. By comparison, the average wage in 1999 was Hr 186 ($37) per month. Moreover, the average pension retirement income as a percentage of the average wage (the "replacement rate") has declined from 43 percent in 1993 to 35 percent today. The target replacement rate in many countries is between 60 and 70 percent.

2. Widespread Contribution Evasion: The shadow economy represents a major portion of economic activity in Ukraine. The informal economy is thought to be 50-70 percent of the formal economy. There is widespread under-reporting of income, and employers further reclassify compensation into categories that are exempt from payroll tax such as free flats, fuel, and income paid in-kind. Clearly, the fact that such a large portion of economic activity escapes the legal structure greatly reduces the amount of pension contributions that the Government of Ukraine (GOU) collects.

3. A Large Number of Retirees: Too few workers in Ukraine are supporting too many retirees, and the problem is getting worse. Ukraine currently has almost14 million pensioners, and only a slightly higher number of workers that contribute to the pension system. This ratio will worsen due to a declining fertility rate.[131] Apart from declining birth-rates, Ukraine's working age population has decreased due to emigration, as workers have left for countries where the average wage is higher. The population declined by approximately 95,000 in 1995, over 120,000 in 1996, approximately 400,000 in 1997, and 200,000 in the *first half* of 1999 (although only a

[131] In 1959, during the baby boom period, the fertility rate was 2.3 percent; in 1966 it was 1.9 percent; in 1997 it was 1.3 percent; and in 1999 it was 0.76 percent.

small part of this decline was due to emigration). Not surprisingly, World Bank projections show that the percentage of the population over age 60 is increasing and will continue to increase (18.7 percent in 1990; 21.3 percent by 2000; 24.5 percent in 2020). In addition, the retirement age of 60 for men and 55 for women is deemed low by international standards. Also, about 12 percent of pensioners work but still receive pensions. The result of these factors is that the PAYG pension system is out of balance, and the situation is deteriorating.

4. Inefficient Administration: The pension system is inefficient and costly. Two entities manage the pension system: the Ministry of Labor and Social Policy (MLSP) and the Pension Fund. Moreover, pension activity is largely handled at the local level and information is not provided to the national pension fund or the MLSP. Thus, the GOU does not have reliable data about what it receives in contributions and pays out to retirees, or exactly who are its employee participants or retirees. Finally, the GOU is not adequately enforcing compliance with the system. In 1998, contribution arrears approached Hr 5 billion ($1 billion), or about 3.4 percent of GDP.

5. An Unpredictable and Unreliable System: Different groups of pensioners, such as miners, military personnel, and child-rearing mothers, receive more pension benefits than others in what seems to be an arbitrary fashion. The State has declared, without a cost-benefit analysis or any ability to deliver, increases in pension benefits that are then ignored because of inability to pay. Some pensioners are paid in-kind rather than in cash (contributions are also sometimes paid in-kind). Pensioners in more economically well-off regions receive benefits more regularly, and in full. Unpredictability and unreliability permeate the pension system.

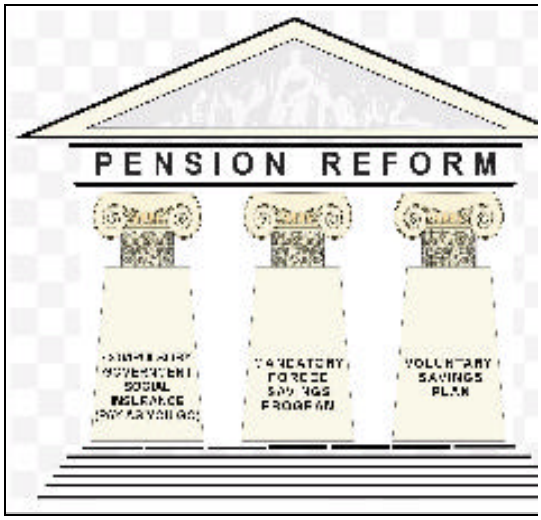
6. A Financially Unsound and Unsustainable System: Despite declining benefits, the amount of pension expenditures as a percentage of GDP has increased steadily from 7.9 percent of GDP in 1995 to 10 percent in 1997. Pension benefit arrears have also increased steadily. According to the International Monetary Fund (IMF), pension arrears were 0.1 percent of GDP in 1995, 1.4 percent in 1996 and 1997, and 1.9 percent in 1998. At the end of 1999, Ukraine had about Hr 1.26 billion ($252 million) in pension benefit arrears. Pension arrears shrank by 47 percent or Hr 1.1 billion ($220 million) from their high point reached on March 1, 1999, with most of the decrease occurring at the end of the year as the GOU repaid pension and wage debts *en masse* before the presidential elections.

7. Benefits Paid Without Regard to Work History: Pension benefits are not closely tied to the amount of wages one has earned over one's lifetime. Instead, the last two years, or some other set of years, can be considered in calculating pension benefits. In addition, years of service credits are available for mothers with young children, military personnel, full-time students, etc. And "social" pensions are granted to people who have never worked, without serious justification. The net effect is that pension entitlements are seemingly arbitrary – nearly everyone receives a pension and the majority of pensioners receive almost the same amount, regardless of work history.

Pension Reform. While these problems may be unusually severe, Ukraine is not alone in having a dysfunctional PAYG system. Similar problems exist in many other nations throughout the world, and this has prompted numerous pension reform efforts. The common element of these reform efforts has been a fully funded mandatory savings plan that creates a direct link between the employee's contribution and the employee's ultimate benefits upon retirement. One of the advantages of this mandatory, or forced savings, approach is that it creates an asset base that is used to fund pension benefits (as opposed to a mere promise of a government to pay). Another advantage is the potential, over time, to create capital pools which can be

put to productive use in the economy. First and foremost, of course, the pension assets must be managed carefully on behalf of the beneficiaries, with their well-being at retirement the paramount concern, ahead of targeting the funds to revitalize the economy.

Pension reform is a complicated and major initiative. The discussion is generally framed in terms of the "three pillars" of pension reform: 1) a continued compulsory government social insurance scheme that pays defined basic benefits to the currently retired, and soon to be retired, financed on the PAYG basis (pillar one); 2) a mandatory forced savings program where a fixed percentage of an employee's wages is set aside, privately managed, and invested in an individual account, to gain in value and ultimately provide the retirement payments stream (pillar two); and 3) a voluntary savings plan that allows workers to set aside part of their wages – free of income tax until the funds are withdrawn at retirement – for investment in privately managed individual accounts to grow over time and supplement retirement income (pillar three). Many permutations from this basic framework have been implemented around the world.



Careful operational practices and investment guidelines are imperative with respect to pillars two and three. These should be mandated by law. The management of private pension funds, particularly pillar two funds, must be carefully monitored and subject to even tighter regulation than investment funds (investment fund regulation generally relies more on requiring disclosure of risks). Pension funds must be:

- Low risk: The probability of default or serious erosion in value must be very low so that the expected money is available at retirement. Investors may choose to make high risk investments for the potential high return on such investments, but they must use personal savings, not pension assets, for such investments;
- Liquid: It must be possible to buy or sell the securities in the portfolio quickly and easily, on the organized market, so that the pension fund manager can meet the cash needs of the pension fund;
- Diversified: Diversification – assembling a portfolio of securities from many different countries, regions, industries and types of companies – reduces risk. This is essentially the familiar idea that you "should not put all your eggs in one basket"; and
- Securitized: It is not appropriate for pension assets to be invested directly in real estate, public infrastructure, or individually negotiated business deals. Such investments are highly illiquid, driven by transaction specifics, and require expertise not generally possessed by investment advisers. If such investments can be grouped together and "securitized," however,

regulators could consider allowing a limited percentage of pension fund assets to be invested in such securities.[132]

Commonly, governments require that most of the funds in mandatory and/or voluntary pension plans be invested domestically, mostly in that government's debt instruments. Today, however, the financial markets of Ukraine are not sufficiently developed to allow pension assets to be safely invested in the country. The "default" on treasury bills at the end of 1998 demonstrated that these instruments are unreliable; shares are not underpinned with reliable financial accounting and disclosure; and neither government bonds nor shares have liquid markets. Ukraine should only consider mandatory pillar two reform if it is prepared to initially require that a preponderant portion of the assets in individual accounts be invested *outside* of Ukraine in a mix of foreign investment grade assets such as top-rated government debt (e.g., US or European treasury obligations) and "blue chip" foreign equities indexes (Standard & Poor's 500, FTSE 100, CAC 40, etc.). This investment requirement can be changed over time as the domestic markets develop and mature. "Fiduciary duty" must be paramount over other concerns.

Yet, it is repeatedly asserted that it is "politically unacceptable" to require that all or most pension assets be invested outside the country. Some point to the potential impact on the national budget and on the balance of payments if assets are invested outside the country (or in any asset class other than domestic government debt obligations). This deserves careful discussion. Ukrainians would benefit greatly from world class investments that gained real market rates of return from widely diversified assets.

For purposes of discussion, however, let us assume that policymakers do in fact require that at least some percentage of pension assets be invested domestically. Then, creative methods must be considered for putting pension assets to work within Ukraine while allowing sufficient liquidity and not endangering the pension assets. For example, it has been suggested that some assets could be invested in Government debt obligations, indexed to provide a return that keeps pace with inflation, or, better yet, indexed to the dollar or Euro. This money would in turn be provided to productive enterprises in the form of secured loans. This plan would expose the Government – and pension assets if the Government were unable to perform – to considerable risk, but thought should be given to this and other proposals. Efforts to develop "securitized" products are another possible solution, as discussed in footnote 132.

Licensing requirements for pension fund management companies and custodians should be strict. Perhaps only an entity with foreign experience and foreign ownership initially would qualify. This would serve to ensure that international best practices are brought to Ukraine. Any scandal involving pension funds will do immeasurable damage to people's confidence in, and willingness to support, a reformed pension system.

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[132] Individually negotiated investments in start-up or small businesses can be "securitized" by venture capital closed-end investment funds. Such funds issue liquid securities to raise money and, in turn, provide equity or debt financing to small businesses. Similarly, investments in infrastructure such as bridges and highways can be "securitized" by oblast and municipalities that invest in such infrastructure and in turn issue bonds. Finally, illiquid investments in real estate can be "securitized" by real estate investment trusts – companies that take equity positions in real estate projects, or loan money to real estate developers, and in turn issue liquid securities.

Adjustments to the existing pillar one system, such as raising the retirement age, and introducing personal pension accounts (as in the L'viv pilot program) are also important.[133] Positive pillar one improvements are occurring. With USAID support, the GOU has established a new Office of the Actuary to provide analysis and advice on pension policy issues. Previously the GOU did not use analytical tools or methodologies to make pension policy decisions or budget impact assessments. The GOU is also spending $20 million to improve the pension information management system. And the pension system generally is being restructured to be more responsive and efficient. Finally, committees within the GOU and the Verkhovna Rada are working to develop pension policies and legislation. Draft laws are being developed which would modify the pillar one system and create a pillar two system.[134]

The Draft Law "On Non-State Pension Funds." There are several versions of a draft law "On Non-State Pension Funds" in circulation that would introduce a pillar three pension system. Whatever final version emerges, it should comply with five key principles:

- Participants' assets must be kept in a legal entity *separate* from the pension fund management company – perhaps in a non-commercial organization.[135]
- All of the assets of each plan must be kept in a single, well-capitalized custodian. All contributions should go directly to the custodian and never be in the possession of the management company. A *single* custodian is necessary so that the custodian can view the entire portfolio and thus serve as a "watch dog," reporting to the relevant regulatory agency any activities of the pension fund management company (or investment adviser, if separate) that violate legislation or the pension fund statutes.
- Strict SSMSC regulations must require that investments be low risk, liquid and diversified. Initially, pillar two pension funds should be required (and pillar three pension funds permitted) to invest a significant portion of their assets in foreign equity securities, foreign equities indexes and foreign debt, until domestic markets are more developed.
- Pension funds must be prohibited from making investment guarantees (i.e., no "defined benefit" plans). This is more properly the activity of an insurance company. Investment guarantees require specific expertise in asset/liability matching, "immunizing" portfolios against changes in interest rates, and sophisticated actuarial calculations. They also require access to a highly liquid medium and long-term bond market as well as sophisticated financial instruments such as options and futures.
- Pursuant to the principle of functional regulation, the SSMSC should regulate investment adviser activity (management of the securities portfolio) whether performed by a pension fund management company itself or by an external investment adviser. Another regulatory body –

[133] See footnote 211.

[134] Work is ongoing on a draft law "On Mandatory State Pension Insurance" which would, among other things: i) raise the pension age incrementally to be equal for both men and women; ii) allow retirement either at the retirement ages contained in current law, with reduced benefits, or later, with increased benefits; and iii) introduce a new formula for calculation of pillar one benefits that includes a gradual lifting of the system's maximum benefits cap, phased increases in the number of years' wages considered when calculating "monthly average wage," and annual adjustments to the wage cap (the maximum wage used for calculation of benefits and payroll contributions).

[135] See footnote 127 and related text.

perhaps a newly created "State pension inspectorate" – should regulate the other activities of a pension fund management company, such as marketing, contracts between the fund and participants, client relations, back office activities, accounting, and pricing activities.

The draft law "On Non-State Pension Funds" should be improved, in compliance with these five principles, and passed. Supporting regulations should then be drafted and enacted.

Other steps are needed for serious pension reform. The Pension Fund must be restructured so that it has the capacity to manage its operations efficiently. The GOU capacity to effectively regulate pension funds needs to be expanded. Key policymakers need a sustained educational program to clarify for them the different types of pension reform efforts other nations have implemented. And public education is needed so that everyone, not just policymakers, understands the issues surrounding pension reform. Finally, institutional capacity needs to be expanded to administer and manage public and private pension schemes that are reliable, efficient and effective.

Existing Third Pillar Pension Funds. There are approximately ten third pillar pension funds active in Ukraine, down from 40 in 1997. These are voluntary, private pension funds operating without any controlling law or regulatory oversight. They are organized as joint stock companies (closed and open), limited liability companies and companies with additional liability, and they do not have management companies, custodians, investment declarations or fund rules. Assets are commingled with founders' assets. Most invest in bank deposits, although a few invest in real estate or more exotic investments.

A scandal involving these funds would further erode Ukrainians' confidence in pension funds specifically and financial markets institutions generally. Reorganizing these funds would be very difficult, given their structures, and thus immediate steps should be taken to close them.

Benefits of Pension Reform. The greatest benefit of successful pension reform is that a nation's retirees and workers will know that their retirement savings are secure and sufficient. Numerous residual benefits should also follow. Successful pension reform can reduce the problems associated with the current PAYG (pillar one) system (in particular the burden on current workers supporting too many retirees), increase the fairness and efficiency of the pension system, and promote savings and capital formation. Pension reform will speed the development of financial markets infrastructure generally and increase the number and sophistication of market professionals. The key financial markets institutions, products and skills needed in connection with pension reform are those that foster a nation's economic growth generally, such as management companies, investment advisers, annuity and other insurance products, banks and custodians.[136]

A Different Solution. Epigrams are true: Do not reinvent the wheel. Ukraine could take precisely this wisdom and apply it to developing its collective investment institutions. Ukraine need not, now, reinvent all the legal and operational structures for custodial and asset management activities that already exit in mature economies. Rather than drafting detailed laws now and attempting to develop a domestic industry,

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[136] Annuity products are insurance instruments that pay a secure and steady stream of income to pension beneficiaries during the period of retirement. They can be purchased with an individual's accumulated pension funds in order to ensure a fixed income without investment risk.

Ukraine could hold an international tender offer that asks (by the terms of the tender) only the world's best qualified custodial and money management firms to come to Ukraine and set-up operations. If done properly, the tender offer could result in firms such as State Street Bank, or Fidelity, or Deutsche Bank, or Credit Suisse Group and their world-class competitors coming to Ukraine to jump start collective investment institution development and immediately begin knowledge transfer of best practices. Partnerships with local Ukrainian firms could be encouraged to facilitate this transfer of knowledge.

By way of example, the tender could require that the custodial and money management firms permitted to bid must have been in existence for a minimum of 10 years; have a minimum of $20 billion under custodial or management control; and currently service a minimum of 15 million individual accounts. The purpose would be to capture the attention of the leading custodial and money management firmsin the world, and present them with an opportunity for a serious long-term franchise to operate in Ukraine, and to do so under the laws and operational procedures under which they are currently operating. By example, one custodial franchise could be awarded for 10 years and five money management franchises could be granted for 5 years. The tender would require that qualified bidders set forth their proposed fee structures – Ukraine would thus gain the benefits of competitive market forces through the initial international tender competition.

This approach would accept the wisdom of using the comparative advantages of the global markets to assist Ukraine. It would maximize the protections against the three central risks that presently impede collective investment institution development in Ukraine (fraud, risk management, operational implementation). And it would be a dramatic statement to the world community about Ukraine's openness and commitment to reform.

Action Points:

- **Support the Securities and Stock Market State Commission (SSMSC) and State Property Fund (SPF) in their effort to develop an orderly procedure to reorganize existing "privatization" funds into open-ended funds or to liquidate them (subject to separate administration and a separate legal regime from new investment funds);**

- **Finalize and pass the draft law "On Collective Investment Institutions (Unit and Corporate Investment Funds)," consistent with the principles outlined in this Chapter. Most significantly, modify the current version of the draft law to require separation of investors' assets from the assets of management companies;**

- **After passage of the collective investments law, draft and enact the required supporting regulations, and begin training a group of investment advisers to manage a fund's securities portfolio;**

- **Complete development of laws that would improve the pay-as-you-go (PAYG) (pillar one) pension system and create a forced savings (pillar two) system;**

- **Finalize and pass the law "On Non-State Pension Funds," consistent with the principles outlined in this Chapter, to create a voluntary pension system of privately-managed individual accounts (pillar three system);**

- **Ensure that careful operational practices and investment guidelines are mandated by law with respect to the pillar two and three systems, and that the management of private pension funds, particularly pillar two funds, is carefully monitored and subjected to an even higher level of scrutiny than investment funds;**

- **Initially, require that a preponderant portion of the assets in pillar two pension funds be invested outside of Ukraine in a mix of foreign investment-grade assets such as top-rated government debt and "blue chip" foreign equities indexes, and permit pillar three pension funds to invest in such assets. This requirement can be changed over time as the domestic market develops;**

- **Restructure the Pension Fund so that it has the capacity to manage its operations efficiently;**

- **Conduct an educational campaign for the relevant policymakers to clarify for them the different types of pension reform occurring in other countries, as well as a public education campaign so that everyone, not just policymakers, understands the issues surrounding pension reform;**

- **Work toward expansion of the institutional capacity needed to administer and manage public and private pension schemes that are reliable, efficient and effective;**

- **Close the (approximately ten) third pillar pension funds (i.e., private, voluntary funds) currently active in Ukraine because they**

are operating without oversight or a legislative framework unless they could be reorganized to operate within the new pillar three system; and

- **Consider implementing a different solution to pension reform. Rather than drafting detailed laws now and attempting to develop a domestic industry, consider holding an international tender offer that asks (by the terms of the tender) only the world's best qualified custodial and money management firms to come to Ukraine and set-up operations (pursuant to the laws and operational procedures under which that they are already operating).**

7. Corporate Governance: Restructuring and Attracting Capital

Enterprise Restructuring – the Search for Efficient Owners. The initial emphasis of privatization in Ukraine was ownership transfer – from the State to shareholders. But that transfer of title is only the superficial stage of privatization. Meaningful privatization only occurs when the newly owned enterprises are restructured to run more efficiently and gain the benefits of private ownership. Marketing and sales skills must be sharpened, new production technologies and management methods introduced, quality control increased, new markets found, effective incentive structures introduced, improved information management systems put in place, staffing levels reduced to appropriate levels, product lines closed and new ones initiated, and so on. Such restructuring is one of the main goals of corporate governance.

Corporate governance can be defined as the system of elected and appointed bodies that govern the activities of a company. Corporate governance is intended to ensure that the management of the company acts in furtherance of the interests of its owners in maximizing profits and share value, within legal limits.[137]

Corporate governance should thus facilitate post-privatization corporate restructuring. In Ukraine, however, privatization has not dramatically improved productivity or profitability, primarily because privatization has not led to corporate restructuring. This is because too many vestiges remain from the old socialist system. As a rule, Ukrainian companies continue under the same management, with the same compensation schemes as they had under State ownership. The form of management bodies has changed, but the individual managers often have not – the average tenure for current directors is in excess of ten years.[138]

Moreover, the main activities of firms, despite generally shrinking business, remain the same, with a continued focus on the same customers and suppliers and an emphasis on sales within Ukraine. Management still believes that its ties to State-owned enterprises, and the ability to generate sales from them, are critical. Despite falling sales and financial difficulties, firms continue to do business primarily with the same partners with which they worked under the Soviet system, often without even a marketing department or business plan. And finally, firms continue with the same product mix and the same quality standards as before privatization. Thus, as

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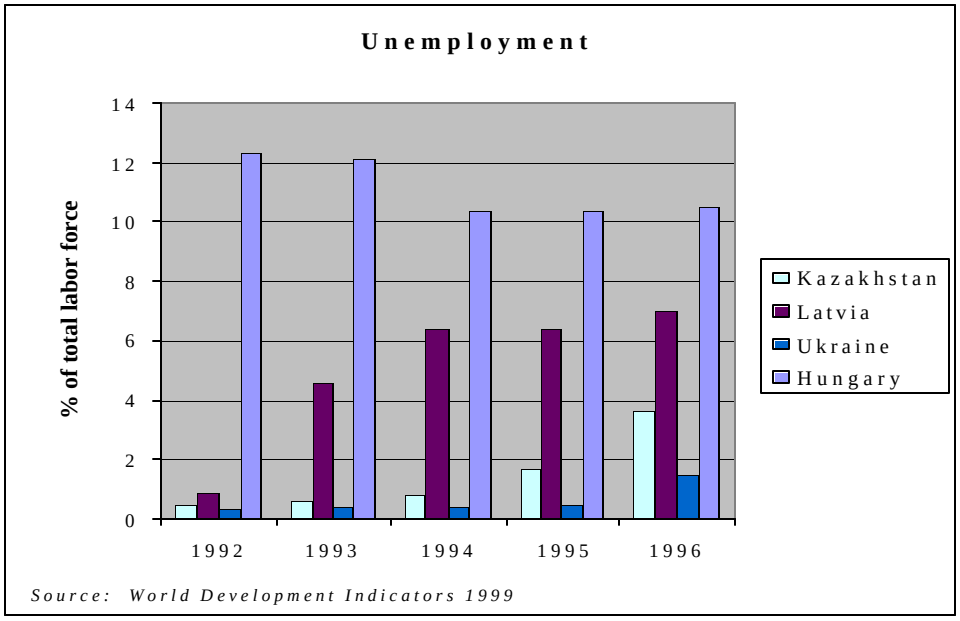
[137] The World Bank offers a more comprehensive definition: corporate governance refers to that blend of law, regulation and appropriate voluntary private sector practices which enable a company to attract financial and human capital, perform efficiently, and thereby perpetuate itself by generating long-term economic value for its shareholders, while respecting the interests of other stakeholders (i.e., creditors, employees, suppliers, customers, others affected by the actions of the company, and society as a whole). The principal characteristics of effective corporate governance are: transparency (disclosure of relevant financial and operational information, and internal processes of management oversight and control); protection and enforceability of the rights and prerogatives of all shareholders; and, supervisory board members capable of independently approving the corporation's strategy and major business plans and decisions, and of independently hiring management, monitoring management's performance and integrity, and replacing management when necessary.

A more concise definition would be: "The ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." Shleifer and Vishney (1997).

[138] This data is based upon a survey of Ukrainian companies in 1998 by economists Estrin and Rosevar.

measured by the amount of restructuring that is occurring, it appears that corporate governance is not having a substantial impact in Ukraine.



Why no wide scale restructuring? There are several reasons. First, private ownership of shares is widely dispersed and unorganized. Shareholders lack expertise and resources, and thus few effective proposals for restructuring are put forth. Accumulation and concentration of capital with strategic investors (efficient owners) capable of instituting real change has been slow. Even when outsiders are able to acquire a significant holding, and have the expertise and resources to bring about change at a company, that change is often thwarted by entrenched management and a legal regime that does not empower minority shareholders.

Managers are often profiting from the current structure and have little motivation to institute broad changes themselves. Many managers and controlling shareholders have decided that it is easier and more profitable to find creative ways of skimming profits and stealing the assets of companies rather than restructuring and expanding them. In addition, the proper incentive system is not functioning: companies practicing good corporate governance are not rewarded with increased investment (because of the weak overall market), and companies practicing bad corporate governance are not exposed or subjected to penalties. Finally, the possibility of using cash substitutes (barter and negotiable instruments (veksels)) encourages companies to get by with subsistence level operations and avoid bankruptcy. Bankruptcy, however, is exactly what is often needed as a way of reorganizing companies and giving them a fresh start (or, in some cases, liquidating them).[139] Enterprise managers must feel that they could lose their jobs, either in a liquidation or bankruptcy restructuring, if the enterprises they manage are insolvent.

[139] In Ukraine, liquidation is generally less desirable than reorganization because there are few purchasers for liquidated assets, and because, due to the lack of an entrepreneurial tradition, start-up companies are slow to replace those dismantled. The usual test for liquidation in a bankruptcy proceeding – will creditors receive more in liquidation than in a reorganization? – is met much less often in Ukraine than in Western countries. See Box 2.1.

Attraction of Capital. In addition to playing a role in fostering restructuring, good corporate governance is also crucial for enterprises to attract capital. Enterprises in Ukraine are in critical need of capital to modernize their production facilities, restructure their operations, and expand into new areas. Enterprises have two potential sources of capital – creditors and strategic investors – and good corporate governance practices are important to both. An enterprise will be able to attract capital if the providers of capital believe that their rights will be protected. On the other hand, if the law and the company's internal documents allow management or a controlling shareholder to direct the company's affairs for their private benefit, then no loan or equity investment will be forthcoming.

Principles of Corporate Governance. Certain basic principles of corporate governance are fundamental.[140] These include:

1. One common share, one vote: Each share of common stock should grant its owner one vote. Different classes of common shares should be prohibited.[141] Preferred shares of open companies should grant voting rights only in certain carefully defined circumstances. Pyramid and circular holding structures should be discouraged. These rules are important to insure that there is a tight correlation between ownership and control; when this correlation is loose, those who have control but not ownership have an incentive to convert profits and assets for their private benefit.

2. Equal and fair treatment for all common shareholders: All dividends, property of the company distributed to common shareholders upon liquidation, appraisal and redemption rights, preemptive rights, notices of general shareholder meetings, annual reports, rights to participate in general shareholder meetings, and rights to review materials necessary for general shareholder meetings should be distributed fairly and equally to all common shareholders.

3. Shareholder approval of important decisions: The most significant corporate decisions should require approval of a majority or super majority of common shareholders. Such key decisions include the following:

- Introducing changes to the company's charter or internal documents;
- Making a decision to increase or decrease the statutory fund;
- Approving the amount of dividends;
- Making a decision on reorganization or liquidation of the company;
- Electing members of the company's supervisory board;

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[140] The Organization for Economic Co-operation and Development (OECD) has developed a more extensive set of "Corporate Governance Principles" that policymakers may want to consider. These are non-binding principles intended to assist member and non-member Governments in their efforts to evaluate and improve the legal, institutional, and regulatory framework for corporate governance in their countries. Available at www.oecd.org//daf/governance/principles.htm.

[141] Different classes of common stock are often allowed in developed economies, but are generally considered inappropriate in transition economies. Even in a transition economy, however, closed companies can be granted more flexibility to structure alternative financing arrangements, including different classes of common shares and preferred shares with various voting right structures.

- Approving the auditor of the company;

- Making a decision on the company's acquisition of its own shares;

- Making a decision on concluding a major transaction (e.g., more than 50 percent of the value of total assets); and

- Making a decision on concluding a transaction in which a member of the management or supervisory boards or a controlling shareholder is personally interested (affiliated person transactions).

4. Accountability and reporting: Shareholders should be provided with periodic statements (e.g., annual reports), special reports, and information necessary to make decisions at a general shareholders meeting. Shareholders must be informed about management's performance and about all important events affecting the company. Shareholders should receive timely notice of all general shareholder meetings, with an unfettered opportunity to attend or appoint a representative.

5. Protection against share dilution: A company should be required to issue its securities only at their market value, and all common shareholders should have equal, well-defined preemptive rights to acquire additionally issued shares;

6. Cumulative voting: Minority shareholders should be given the opportunity to elect a representative to the supervisory board, through cumulative voting or another method. It would be unfair, and would discourage investment, if a shareholder owning 51 percent of the common shares outstanding were able to elect 100 percent of the supervisory board;

7. Control transactions: Persons acquiring a control block of shares of a company should be required to offer to purchase shares from all remaining shareholders, unless the general shareholders meeting votes to waive this right;[142] and

8. Creditor protections: Creditors should be protected through provisions that prevent transfers of wealth to shareholders – through payment of dividends, or purchases by the company of its own shares – when a company is unable to meet its obligations to creditors.

Corporate Governance in Ukraine. Current corporate governance practices of Ukrainian enterprises are not acceptable by international standards. The current law governing joint stock companies, the law "On Business Associations," allows companies to harm shareholders and creditors, while technically complying with the law.[143] Four practices are of particular concern to investors:

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[142] Policymakers must decide what percentage of the common shares outstanding constitutes a "control block" for purposes of this rule. If the percentage is low, it can discourage the appearance of strategic investors, because such an investor must have sufficient assets to offer to purchase all outstanding shares. If the percentage is high, minority shareholders are less protected because they may not be able to exit the investment at a reasonable price if they suspect that the new controlling shareholder will direct profits to himself or to an affiliated entity.

[143] Coincidentally, two of the more high profile corporate governance scandals in Ukraine have involved tire manufacturers: Rosava and Dniproshina. Rosava, located in Bila Tserkva, is approximately 76 percent owned by the State and 24 percent by Ukrainian and foreign investors, who invested more than Hr 50 million ($10 million). A general shareholder meeting, held on January 14,

- Share dilution: share dilution results when companies issue shares to managers or favored investors at below market value, thus diluting other shareholders' interests. Share dilution results in an investor's percentage ownership of a company shrinking, while the value of the overall company increases by a much smaller percentage, if at all.

- Asset stripping: asset striping refers to a company's transfer of assets, at below market value, to an entity affiliated with management or affiliated with a large shareholder (or the State). Shareholders are thereby deprived of the value of their investment for the purpose of insiders' self-enrichment.

- Profit skimming: the term profit skimming ("diversion of cash flow," "non-market transfer pricing") covers a wide variety of methods managers or large shareholders use to divert profits to their private benefit. For example, the schemes involving raw materials traders, discussed in Chapter Eleven, are a form of profit skimming.

- Transactions involving "off balance sheet" entities (i.e., subsidiaries): subsidiaries in Ukraine are generally created with the official task of providing inputs to, and selling finished goods of, the parent company. But often businesses are structured so that profits accrue to subsidiaries rather than to the parent company because, as private entities, subsidiaries have only a few owners and have more flexibility in rewarding employees. Profits thus move from the shareholders of the parent company to the persons in control of the subsidiary. Subsidiaries also allow parent companies to show losses and thus obtain privileges from the Government.[144]

1999, passed a decision to transfer most of the attractive assets of the company to a newly created joint venture. Shareholders did not receive adequate information before the general meeting about the proposed deal. The meeting agenda stated only: "approval of agreements entered into by the management board." Moreover, attempts by shareholders after the meeting to get information from the company were unsuccessful. The joint venture partner is an Irish limited liability company, Tapistron Ltd., created in 1998, about which little is known other than that it is not involved in tire production and was selected without a tender process. Beyond failure to adequately disclose information to shareholders, creation of the joint venture may have violated the law "On the State Privatization Program," which disallows alienation by a company of more than 25 percent of its assets during the process of privatization. Further, the entire general meeting may have been invalid because the Chairman of the State Property Fund (SPF) had apparently canceled the SPF representative's power of attorney before the shareholders meeting (without these shares, there was no quorum).

Dniproshina, located in Dnipropetrovsk, was considered one of the more promising companies traded on PFTS in 1997. It attracted foreign investments and high expectations regarding future growth. At the end of 1997, however, the management of the company approved a third share offering to increase the statutory fund by 33 percent. Shares were placed at nominal value, Hr 9.16, to the company founders and a selected investor at a time when the shares were trading on PFTS for more than Hr 60. Other shareholders were precluded from purchasing shares in the offering. After this "dilutive" share placement to insiders, the price of Dniproshina shares on PFTS plunged, and liquidity dried up. The incident adversely impacted the perception of the Ukrainian securities market and the reputation of the SSMSC.

[144] Chapter Eight discusses the importance of consolidated financial statements that would show the combined activity of a company and all its subsidiaries.

To address these problems, a "Special Task Force on Corporate Governance and Shareholder Rights" was formed on April 9, 1998. The Task Force has drafted regulations and "explanatory notes" aimed at improving corporate governance, many of which have been adopted by the Securities and Stock Market State Commission (SSMSC). The Task Force has also drafted a new law "On Joint Stock Companies" which should protect shareholders' and creditors' rights and significantly improve the investment climate in Ukraine. The draft law tries to strike a balance – protecting minority shareholders' interests while allowing controlling, strategic investors the flexibility they need to restructure and manage companies.[145] The law would replace, in part, the current law "On Business Associations," vastly expanding the sections that relate to joint stockc ompanies.[146]

Passage of the law "On Joint Stock Companies." The proposed Law of Ukraine "On Joint Stock Companies" should be passed as soon as possible. The shareholder and creditor protections in the draft law would go a long way toward assisting enterprises in attracting desperately needed capital – from both strategic investors and from creditors. In addition, by empowering shareholders, the law would facilitate corporate restructuring which, in turn, would begin to revitalize the economy.[147]

Promote Reform at Companies Now. Although not compelled by the current law "On Business Associations," many of the above-noted protections for creditors and shareholders, as well as other useful provisions, can be added to a company's internal documents. Several enterprises in Ukraine have already begun to make these changes in order to attract investment. For example, equal preemptive rights for all common shareholders, cumulative voting for election of supervisory board members, and provisions requiring shareholder approval of major transactions and transactions in which a manager has a personal interest (affiliate transactions), can be added to a company's charter. A "model" charter and by-laws with many of these

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[145] If protections for minority shareholders in the law are too strict, it may be difficult to attract strategic investors. If protections are too weak, investors will be unwilling to hold minority stakes, market liquidity will dry up, and access to capital will be diminished. A market where every investor feels that he must own 75 percent of the outstanding common shares of a company in order to protect himself will be inefficient, illiquid and dysfunctional.

[146] In addition to joint stock companies, the law "On Business Associations" also covers limited liability companies (LLC), companies with additional liability and partnerships. Partnerships could be regulated by the civil code alone, but LLCs and companies with additional liability must be addressed in a separate law. In Russia, for example, a new LLC law, based on a model LLC law for CIS countries, was recently passed.

[147] The draft law, to the extent possible, relies on actions by direct participants in the joint stock company (shareholders, the supervisory board, managers) rather than indirect participants (judges, regulators, legal and accounting professionals). Among other things, the draft law: i) contains protections against share dilution, asset striping, profit skimming, and improper transactions with subsidiaries; ii) defines more precisely the roles of the various bodies of a company; iii) requires that large transactions be approved by the supervisory board or, if large enough, by the general shareholders meeting; iv) limits dividends and acquisition by the company of its shares in order to protect the interests of creditors when a company is insolvent; v) provides for appraisal and redemption rights for shareholders that vote against for a reorganization, major transaction or charter amendment limiting their rights; vi) provides for liability of managers and directors; vii) prohibits issuance of shares at other than market value; viii) defines and requires preemptive rights; and ix) requires cumulative voting so that minority shareholders are represented on supervisory boards.

protections is available to companies now.[148] In addition, companies can add creative provisions in loan agreements with creditors to provide assurances that their interests will be protected. These measures will go a long way to allay investors' and creditors' fears of share dilution, asset stripping, profit skimming and other abuses.

These efforts should be encouraged and expanded. Articles in the press, seminars and conferences, work directly with enterprises, and work through market intermediaries, all can be used to explain to enterprises and their shareholders what can be done now to make enterprises more attractive for investment. In addition, trade organizers can require that companies, in order to be listed, include provisions in their internal documents that protect investors. Investors would thus be assured, without doing further research, that the internal documents of companies listed on that exchange or electronic stock market – or perhaps listed in one of the higher tiers – contain certain basic shareholder protections. These companies, in turn, would have greater access to capital. Finally, these provisions could be added to the model charter that the State Property Fund (SPF) recommends for companies in the process of privatization; even better, the provisions could be mandatory for such charters.

Supervisory Boards. Supervisory boards play a key role in corporate governance.[149] Supervisory boards are elected by shareholders and serve as a company's highest body between general meetings. They exercise the powers vested in them by law, a company's charter, or delegated by the general meeting.

Although supervisory boards work in concert with management, they should be independent of management, and should include several "independent directors" that do not, and have not previously, worked for the company. Supervisory boards oversee managers and defend the interests of the company and its shareholders. They generally approve the company's strategy, budgets and key agreements, identify risks that the company faces and ensure that these risks are properly managed, and ensure that the company has good internal controls and information management systems that provide a timely, clear picture of the company's operations. Supervisory boards also oversee communications with shareholders, consider complaints of shareholders dissatisfied with management decisions, and (usually) set compensation of top officers.[150]

Supervisory boards in Ukraine are not always performing all of these functions. Sometimes supervisory boards are "captured" by management. In other cases, members do not have the knowledge or skills necessary to properly supervise

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[148] The International Finance Corporation (IFC) has published a Corporate Governance Manual that includes a model charter and by-laws, available at: www.ifc.org/europe/corpgov.htm.

[149] Ukraine generally follows the German corporate model involving a two board structure – a management board and a supervisory board. Members of the management board may not be members of the supervisory board. Unlike in Germany, however, workers are not automatically represented on the supervisory board, although workers' representatives have the right to attend supervisory board meetings.

[150] Members of the supervisory board should ideally have: i) the trust of other shareholders; ii) the ability to relate, on behalf of all shareholders, to the interests of all parties and make well-reasoned decisions; iii) professional experience, education and contacts useful to the company (such as business experience, knowledge of relevant national issues and trends, or expertise in technologies used by the company); and iv) an ability to translate their knowledge and experience into solutions that can be applied to the company. (IFC Corporate Governance Manual).

management, set strategy, identify risks, and so on. In many cases, members do not have the information from the company that would be necessary to perform these tasks. An intensive and sustained effort is thus needed to train supervisory board members throughout Ukraine and give them the tools they need. Good corporate governance will require that supervisory boards begin to play a larger role.

Management. Attracting "efficient owners" and training supervisory boards will only improve performance if these changes improve the management of companies. Managers are responsible for the day-to-day operations of the company and for carrying out the decisions of the general shareholders meeting and the supervisory board. Managers must learn new skills, including all aspects of modern business plans and information systems. Thus, wide-spread training of managers in market-oriented techniques is needed. In the end, it is managers who actually implement the changes that will increase performance.

Obstacles to Restructuring. Policymakers should work to reduce barriers to restructuring. For example, strict provisions from the 1971 Labor Code, Government regulations, and political pressures (particularly with State-owned enterprises) make it difficult to lay off workers and managers, which, in turn, greatly inhibits restructuring.[151] Thus, a new market-oriented labor code that protects workers' rights but simplifies the process of restructuring and layoffs should be developed and passed. Restructuring is also inhibited by other factors, such as the fact that workers seeking new jobs often face a lack of affordable housing in new locations, and the slow growth of the small and medium-size enterprises that absorb laid-off workers in most countries.[152]

Certain sectors of the economy are still dominated by monopolies. Where enterprises are exercising monopoly power and the current scale of operations is not necessary for economies of scale, these enterprises should be broken up in order to encourage efficiency-stimulating competition. Where economies of scale are important, such as in the aerospace industry, ancillary units should be spun-off, where possible, to operate as independent suppliers to multiple buyers, and efficiency of the core monopolies should be encouraged by removing any artificial barriers to international competition.

Enforcement of Corporate Governance. In the United States there is no Government body broadly charged with overseeing all aspects of corporate

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[151] Privatization and deregulation are intended to create a competitive economy – to subject enterprises to the discipline of competition in the context of hard budget constraints. Pursuant to the same logic, this principal should be extended to the labor markets. In addition to being important so that enterprises have the flexibility to restructure, deregulation in the labor market will create efficient labor mobility, and performance-enhancing competition between workers to improve performance, acquire new skills, and so on. Restrictions on firing are thought to cost more jobs overall in an economy than they save. Williamson (1997).

[152] Progress has been made toward reducing one important obstacle to restructuring. When the land under buildings has not yet been privatized, managers will tend to wait to sell unused assets, hoping to receive a higher price later when the land can be sold with the building. In the meantime, these assets sit idle and restructuring is delayed. Encouragingly, on January 19, 1999, President Kuchma signed a Decree authorizing the purchase and sale of land under buildings, including unfinished construction cites. Enterprises can now apply to local authorities to purchase the land under the buildings that they own. (This Decree may also give enterprises greater access to credit, because the land can be offered as collateral for secured loans).

governance.[153] In large part, this is left to private lawsuits by shareholders.[154] Private lawsuits, however, are unlikely to be an effective remedy in Ukraine for many years. In part because of this, the SSMSC is constantly requested to take action by shareholders in large and small companies regarding corporate governance violations, including violations connected with general shareholder meetings, dividend payments, actions of managers in contravention of company charters, and so on.

While we believe that the SSMSC should not try to be the "corporate governance police" for all 35,500 joint stock companies in Ukraine, but instead focus on the largest companies where shareholders are widely dispersed and thus less able to protect themselves, we do believe that the SSMSC's enforcement program should include some aspects of corporate governance.[155] Presently, the SSMSC's jurisdiction in this area is not clearly defined.[156] Going forward, policymakers need to decide how far the SSMSC's authority should extend, and define, by law, exactly which provisions of the law "On Business Associations" fall within the SSMSC's jurisdiction.[157]

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[153] The US SEC, in addition to its job overseeing securities market intermediaries, such as brokers and mutual funds, and institutions of market infrastructure, such as exchanges and depositories, is charged with insuring that large "public" companies fully disclose all material information when they sell securities, and also disclose material information to their shareholders on an ongoing basis. This "disclosure of information" responsibility involves the US SEC in corporate governance to some extent. Further, the US SEC's regulations regarding proxy solicitations and tender offers actually go somewhat beyond simply requiring disclosure of all material information and contain substantive (corporate governance) rules. In addition, the US SEC approves stock exchange listing requirements which often involve aspects of corporate governance – e.g., the requirements that listed companies follow the "one-share-one-vote" rule and have an audit committee. Finally, the US SEC investigates companies when it appears that false information may have been disclosed to shareholders. This "enforcement" responsibility might lead the US SEC to investigate aspects of a company's corporate governance. But the US SEC is not broadly involved in monitoring all aspects of corporate governance, such as ensuring that general shareholder meetings are conducted properly.

In addition, Government officials from each of the 50 states play a limited role in enforcing corporate governance.

[154] In the US, lawsuits by shareholders alleging corporate governance violations are facilitated by powerful mechanisms such as: i) "class actions," where large number of shareholders are joined as plaintiffs in one lawsuit; ii) "derivative lawsuits," where a shareholder can sue on behalf of a company to recover damages for the company (such a lawsuit might be against the managers of the company who would not, on their own, direct the company to bring such a lawsuit); iii) "contingency fees," where lawyers work for free, taking their fee as a percentage of damages recovered, and only if the lawsuit is successful; and iv) "statutory attorney's fees," in which certain statutes specify that courts may require that the losing party pay the lawyers' fees of the successful party.

[155] We are familiar with other countries where securities commissions are authorized to enforce corporate governance norms (e.g., the Philippines and Kazakhstan).

[156] Pursuant to the law "On State Regulation of Securities Markets in Ukraine," the SSMSC can impose sanctions for infringements of the "securities legislation." The SSMSC has interpreted this to include some norms of the law "On Business Associations." In addition, a provision was recently added to the law "On Business Associations" stating the SSMSC can "appoint its representative to control registration of shareholders for participation in a general shareholders meeting."

[157] Some measures would clearly be overly burdensome, even if limited to only large companies, such as recent proposals for compulsory training and certification of company managers on securities-related issues.

Post-Washington Consensus

Ten years after the beginning of the post-socialist transition, and in light of the failure of "shock therapy" in Russia, various experts are re-examining the so-called "Washington consensus" that guided the early transition. Is a "post-Washington consensus" now emerging? The following points have been proposed:

- Institution building is the most important factor for progress toward durable growth, and the government should play an active role in helping develop new institutional arrangements. Building institutions means not only organizations and the links between them, but also proper behavior of actors on the economic stage. Institution building involves drafting modern laws, teaching new skills, reforming the tax system, implementing a new pension system, and creating market organizations such as commercial banks, investment banks, mutual funds, an exchange or electronic stock market, a central depository, an independent central bank, a securities commission, a strong budget office, and an independent and incorruptible judiciary.

- The prescripts of the laissez-faire "Washington consensus" that guided the early post-socialist transition – swift privatization, tough monetary and fiscal policy, a stable exchange rate, deregulation and trade liberalization – while important, alone are not enough to generate stable growth.

- Government expenditure should be redirected from non-competitive sectors toward institution building (including behavioral and cultural changes), investment in human capital, and hard infrastructure.

- In post-socialist transition there are many uncharted waters. It may be necessary to orchestrate some institution building innovation in a way previously unseen in other places.

- Corruption and organized crime are the two main maladies that arise in countries when liberalization and privatization are pursued under weak governments. The market expands into the informal sector (shadow economy), while difficulties mount in the official sector. Profits accrue to the informal sector while revenues fall in the official sector, with all the negative consequences for the budget and social policy.

- The judiciary system must be transformed to serve the needs of a market economy. This is a great challenge since the old system of contract execution under planned allocation has ceased to exist, but a new system of contract implementation under market rules and culture has not yet matured. The legal system must begin to provide secure property rights without excessive costs.

- Power should be shifted from the central government to local governments.

- Non-government organizations (NGOs) are the third indispensable pillar of a contemporary market economy and civic society. Their development must be encouraged.

- Although increasing inequity is unavoidable during the initial years of transition, there is a limit of income disparity beyond which the political support for reforms will evaporate. Therefore, seeking growth with equity is important.

- Post-socialist transition to the market is taking place at a time of world-wide globalization. Thus, openness and integration with the world economy is an indispensable part of the transition. Yet these processes must be managed carefully with special attention to short-term capital flow liberalization. In particular, the benefits brought by short-term international lenders are questionable.

- Emphasis should be placed on regional integration and co-operation. Growth requires export expansion, which requires strong regional links.

- In order to improve enterprise performance, good corporate governance is crucial, including improvement of corporate governance of the state sector prior to privatization.

- Tax reform should be pursued through broadening the tax base by lowering tax rates and implementing uniform and fair tax collection principles.

- Bank supervision must be strengthened.

- Educational spending should be increased and redirected toward primary and secondary school.*

* See Grzegorz W. Kolodko, "Ten Years of Post-socialist Transition: the Lessons for Policy Reforms," the Word Bank Development Economics Research Group, April 1999; Joseph E. Stiglitz, "Whither Reform? Ten Years of the Transition," prepared for the Annual World Bank Conference on Development Economics, Washington, D.C. April 28-30, 1999; John Williamson, "The Washington Consensus Revisited," in Louis Emmerij (ed.) "Economic and Social Development into the XXI Century, " Washington, DC: Inter-American Development Bank.

Action Points:

- **Ensure that there is a tight correlation between ownership and control of companies so that those in control do not have an incentive to divert profits and assets to their private benefit. Discourage pyramid structures, cross-holdings, circular ownership structures, and deviations from one-share-one-vote rules;**

- **Finalize and pass the draft Law of Ukraine "On Joint Stock Companies";**

- **Encourage companies to add protections for creditors and shareholders in their charters and by-laws in order to attract investment (based on a model charter and by-laws that is currently available to companies);**

- **Teach companies how to add creditor protections in loan agreements that will assure creditors their interests are protected and thus increase companies' access to credit;**

- **Encourage trade organizers to include in their higher-tier listing requirements provisions that companies must include in their internal documents protecting investors and creditors;**

- **Conduct an intensive and sustained effort to train supervisory board members throughout Ukraine and give them the tools they need to perform their assigned functions;**

- **Conduct wide-spread training of managers in market-oriented techniques, including all aspects of modern business plans and information systems;**

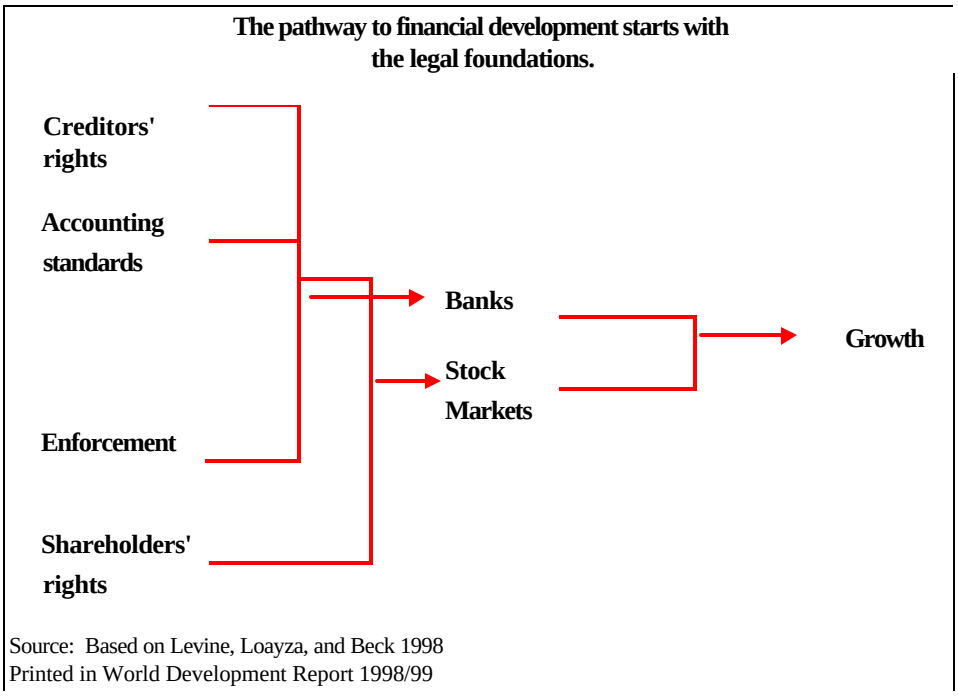
- **Develop and pass a new market-oriented labor code that protects workers' rights but simplifies the process of restructuring and layoffs;**

- **Where enterprises are exercising monopoly power and the current scale of operations is not necessary for economies of scale, break up these enterprises in order to encourage efficiency-stimulating competition. Where economies of scale are important, spin-off ancillary units, where possible, to operate as independent suppliers to multiple buyers, and increase the efficiency of the core monopolies by removing any artificial barriers to international competition; and**

- **Clearly define the Securities and Stock Market State Commission's (SSMSC) enforcement jurisdiction in the area of corporate governance.**

8. Internationally Accepted Accounting and Auditing Practices

Accounting reform is at the center of financial markets development. If financial markets are to efficiently allocate capital to those enterprises best able to use it to expand and create jobs, investors and creditors must have full and reliable information about enterprises seeking capital. The higher the quality of information, the more efficient the capital allocation decisions. Equally important, reliable accounting information and full financial disclosure are necessary for good corporate governance practices, access to international capital, and a fair and effective tax system.



Source: Based on Levine, Loayza, and Beck 1998
Printed in World Development Report 1998/99

The Role Accounting Plays in the Allocation of Capital. Accurate financial information drives investment and credit allocation decisions in a financial market. The current Soviet-style system of accounting in Ukraine, however, does not provide the kind of information that investors and creditors need to make good decisions. Full and accurate accounting information is the best measure of the economic performance of companies. Without such information, capital allocation decisions are haphazard, and the efficiency of the market is greatly reduced. Too much capital is provided to firms that have little chance of success, and not enough to firms with great potential. More specifically, a big problem in Ukraine and other transitional economies is the lack of speed and vigor in dealing with failing companies. There are many reasons for this, including political decisions to support failing enterprises and inadequate bankruptcy procedures, but poor quality financial information plays a role in perpetuating this allocation inefficiency.

The current accounting system in Ukraine is unsatisfactory because it distorts reporting on economic status and activity (i.e., the balance sheet and income statement). On the balance sheet, for example, imperfect indexation (due, in part, to differences between currency depreciation and general inflation) invariably distorts the value of property, plant and equipment. The preclusion on writing off receivables for three years causes overstatement of accounts receivable. And the recognition of the company's own shares as assets on the balance sheet results in total assets

being overstated. There are even more serious problems in the income statement. In most cases, profit is vastly overstated because certain expenses are disallowed. For example, ordinary and necessary expenses related to business trips, advertising, and leases are not deductible. Some social costs, which are often significant, are not considered expenses and are also not deductible.

The consequence of these practices is that company balance sheets and income statements often overstate actual economic status and performance.

In addition to these distortions, there is a crucial piece of information missing – cash flow. The single most important consideration when deciding upon a loan or an investment is the likelihood of receiving a return (principal plus interest on a loan; return of capital, related appreciation and dividends on an equity investment). The amount of cash that a company receives and disburses is one of the key factors used to evaluate this likelihood. Information on cash flow is even more important in an economy dominated by barter, because it allows investors to judge a company's liquidity. No information on cash flow, however, is provided under the Soviet-style accounting system.

The Role of Accounting in Corporate Governance. Both externally and internally, good financial information is a prerequisite to good corporate governance. Without it, there is neither accountability of upper management to the shareholders nor of lower level management to upper management. Assessing the performance of the supervisory and management boards is perhaps the most important aspect of corporate governance, but the Ukrainian accounting system does not currently provide the information needed for this evaluation.[158] Accurate reports on the profitability of a company are needed by shareholders when they decide whether to re-elect members of these boards.

Two specific shortfalls of the Ukrainian system particularly inhibit shareholders' ability to evaluate management. First, consolidated financial information (showing the combined activity of the company and all its subsidiaries) is not required. Second, related party transactions are not a requisite disclosure. Managers of Ukrainian companies can too easily misuse company assets for their own gain through transactions with related parties or "off balance sheet" entities (i.e., subsidiaries). Because of these two deficiencies in Ukrainian accounting, a manager can (personally) compete directly with the company he manages, direct the company to enter into transactions with another entity in which he has an interest, or shift economic gains or losses to a subsidiary. In all instances, information need not be reported to the company or its shareholders. The fact that accounting standards do not require related party disclosures and consolidated financial statements prevents shareholders and creditors from independently evaluating the transactions that may be most detrimental to the company. This presents a significant obstacle to an accurate valuation of a company.

Good corporate governance also requires better financial reporting within a company ("managerial accounting"). It is crucial that management have full and accurate information about the performance of the various components of the enterprise. Just as shareholders need accurate reports on the profitability of a

[158] This section of the Paper covers only the role of "accounting information" in corporate governance. It should be noted, however, that a great deal of other qualitative and quantitative information is needed when assessing the performance of management, such as management incentive systems, product positioning and marketing strategies, new product development plans, methods of responding to competition, and so on.

company, so the upper level managers need reports on the profitability of the various departments, representative offices, branches, subsidiaries, and product lines. Such information is crucial for management to make decisions regarding restructuring of the company. Unfortunately, most companies with complex structures do not have the types of internal management accounting systems that would allow them to accurately measure profitability of the company's various parts. Without such measurements, it is very difficult to efficiently restructure or fine tune the performance of a company, if not impossible.

The Role of Accounting in Attracting International Capital. The problems with Ukraine's current accounting system – its failure to accurately measure financial status and profit, disclose cash flow, show consolidated balances, discuss related party transactions, etc. – makes it difficult for international investors to seriously consider opportunities in Ukraine. International investors who do not have the resources to undertake an independent examination of companies simply go elsewhere to find good investments. However, international investors will reconsider investing in Ukraine if the country can implement an accounting system that provides full and accurate information in accordance with international standards. Simply stated, the more the accounting system reduces examination and monitoring costs, the greater the number of persons willing to invest and the greater the amount they will be willing to pay for the assets of companies in which they invest.[159]

The Role Accounting Plays in Accurately Measuring True Economic Profit for Tax Purposes. The economically appropriate and fair administration of tax policy is also dependent upon a system of profit measurement that closely approximates true economic profit. Without such a system, the tax burden will not be economically and justly distributed.

The Accounting Reform Effort In Ukraine. Accounting reform means replacing Ukraine's Soviet-style accounting system with one that is appropriate for a market economy. The various financial market players have strong reasons to support such a reform effort: i) the Ministry of Finance, (MOF) to improve reporting by enterprises for statistical and taxation purposes; ii) the State Tax Administration (STA), to ensure that enterprises pay taxes in accordance with their true economic profit; iii) the National Bank of Ukraine (NBU), to better assess banks' financial condition, their ability and their customers' ability to repay loans, and to monitor banks' asset-liability matches and reserve requirements; iv) the Securities and Stock Market State Commission (SSMSC), so that reliable information on the financial health of companies is available to investors, encouraging capital formation and secondary share trading and allocating capital to those best able to use it; v) trade organizers and securities traders, to stimulate the securities markets and thus broaden demand for their services; vi) companies, to raise capital from domestic and foreign investors and creditors; and vii) collective investment institutions, to accurately value investments.

The good news is that Ukraine has recently embarked on an ambitious accounting reform project to introduce internationally accepted practices, including National Accounting Standards (NAS) that are consistent with International

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[159] Policymakers in Ukraine have chosen to implement National Accounting Standards (NAS) "consistent with" International Accounting Standards (IAS), rather than simply adopting IAS directly. This decision increases international investors' costs, because they must take time to understand the differences between NAS and IAS. If Ukraine wants to increase foreign investment, it should take steps to reduce those costs, such as publishing and making widely available in multiple languages a definitive guide to NAS that specifically indicates the departures from IAS.

Accounting Standards (IAS). Ukrainian companies will be required to completely change the way they prepare and maintain financial information. On the public side, the Verkhovna Rada, Cabinet of Ministers (COM), MOF, SSMSC and NBU are leading the reform effort.[160] On the private side, the Ukrainian Federation of Professional Accountants and Auditors (UFPAA) is organizing specialists to train accountants that will implement these new accounting practices.

Accounting reform should help solve many of the problems discussed above. Balance sheets and income statements will more accurately reflect enterprises' status and activity, and a "Statement of Cash Flows" will help investors better estimate their expected return on capital.[161]

It is crucial that the adjustment from a company's financial statements to its tax return be as simple as possible. The *interlinkage* between accounting reform and tax reform is discussed more fully in Chapter Nine.

Accounting Reform Next Steps. Completing the development of NAS, along with a new chart of accounts and instructions, and implementing accounting reform throughout Ukraine is a major undertaking.[162] A focused, sustained and coordinated effort involving various State bodies, international donors, non-Government organizations (NGOs), and self regulatory organizations (SROs) is needed to train accountants in the basics of NAS. Creative methods, such as web sites, interactive CD ROMs, telephone hotlines, or conferences and workshops, are needed to reach the largest possible number of accountants across the country. A standardized, easy

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[160] The Verkhovna Rada recently passed the Law of Ukraine "On Accounting and Financial Reporting in Ukraine" which calls for the introduction of international standards by the MOF. The COM passed Resolution No. 1706, dated October 28, 1998, "On Approval of the Program of Reforming the Accounting System with Application of International Standards," which also calls for a broad accounting reform effort. The MOF has mandated the introduction of NAS and has completed and registered with the Ministry of Justice eleven National Standards to date (at least seven more are in draft form). The MOF is also implementing an ambitious "action plan" for accounting reform. The NBU has already introduced a new chart of accounts and IAS-based reporting for banks. The SSMSC has required all open joint stock companies to file annual reports in 2000 using IAS (SSMSC Resolution No. 11, dated January 27, 1998, and No. 92, dated July 29, 1998), although we understand that the SSMSC is considering modifying the proposal so that it applies only to companies above a certain size (a reasonable proposal).

[161] To take one example, the current overstatement of accounts receivable that results from the preclusion on writing off receivables for three years will cease. Under the new accounting standards, accounts receivable will be stated net of bad debts. This change is particularly important in a country with a chronic payments crisis.

[162] One key element of the new standards is footnote disclosure. No detailed information is provided in Soviet-style financial statements to explain how the statements were compiled or to describe assumptions and estimation techniques underlying the numbers. This was considered unimportant because the MOF published a yearly manual specifically detailing the requirements for compiling annual reports. However, NAS allows companies choices in their compilation methods, making disclosure of the techniques applied an important part of the financial statements. Footnote information will be necessary to gain an overall understanding of the financial position and operations of a company. For example, footnotes must explain how revenue is recognized (upon shipment, on a percentage of completion method, on an installment sales method, etc.), and how inventory is accounted for (first-in-first-out, last-in-first-out, average method, etc.).

to understand and widely available methodology for conversion of accounting practices to international standards is also critical.[163]

Longer term, the Ministry of Education and the leading educational institutions must be enlisted to help reform Ukraine's accounting curriculum. Certification of accountants in NAS will also be an important step to be undertaken by professional organizations.

Reform and Development of the System of Independent (External) Audits. The old system of Communist Party control over enterprise directors is gone, and nothing has been put in its place. As a result, many enterprise directors feel free to act in their own self interest, and do so without constraint. In a market economy, a system of independent (external) audits is one of the primary "control" mechanisms over managers. Thus, accounting reform in Ukraine must be accompanied by reform and development of auditing practices. Independent audits in accordance with internationally accepted accounting and auditing practices protect a company's owners from incompetent or unscrupulous managers. Independent audits also play an important role in ensuring the reliability and transparency of financial statements for investors and creditors. Finally, submitting to an independent audit demonstrates a company's commitment to transparency, an attractive selling point to investors.

The current law "On Auditing Activity" needs to be updated to provide for audits based on NAS. Perhaps most importantly, current law allows companies to submit the auditor's report to shareholders and the SSMSC nine months after the end of the reporting period.[164] This delay greatly reduces the usefulness of the information – such stale information is of little value to investors.

Internal Audits. A system of good *internal* auditing is also important for companies to operate effectively in a market economy. Internal audits improve corporate governance by ensuring that the management and supervisory boards are aware of problems in the company. Internal audits also provide an incentive (fear) for company officials to stay honest and follow company procedures. Finally, internal audits assure top managers that they have reliable information about the enterprise with which to improve the company's operations.[165] Training and information should be provided to help companies implement effective internal audit procedures.

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[163] The NBU, in its reform efforts, found that it was crucial to have good conversion tools and a credible threat of penalty for those that do not use them.

[164] Article 24, Law of Ukraine "On Securities and the Stock Exchange."

[165] The internal audit function can be fulfilled by a company's "inspection commission," so long as qualified specialists serve on the commission.

Action Points:

- **After completion of the new National Accounting Standards (NAS), publish and make widely available in multiple languages a definitive guide to NAS that specifically indicates the departures from International Accounting Standards (IAS) so that foreign investors can quickly understand the Ukrainian accounting standards;**

- **Conduct a focused, sustained and coordinated effort, utilizing the resources of various State bodies, international donors, non-Government organizations (NGOs), and self regulatory organizations (SROs), to train accountants in the basics of NAS. This is a major undertaking requiring creative methods to reach the largest possible number of accountants across the country, such as web sites, interactive CD ROMs, telephone hotlines, conferences and workshops;**

- **Develop a standardized, easy to understand methodology for conversion of accounting practices to international standards and make it widely available across the country;**

- **Longer term, enlist the Ministry of Education and the leading educational institutions to help reform Ukraine's accounting curriculum;**

- **Reform and develop auditing practices to ensure that enterprises are annually undergoing independent audits in accordance with internationally accepted accounting and auditing practices;**

- **Update the current law "On Auditing Activity" to provide for audits based on NAS;**

- **Amend Article 24 of the Law of Ukraine "On Securities and the Stock Exchange" to reduce the time period for submission of financial statements and auditor's report; and**

- **Provide training and information to help companies implement effective internal audit procedures.**

9. Taxes, Duties, Fees and Fines

The Effect of Tax Policy on Financial Markets Development. Tax policy is closely *interlinked* with all aspects of financial markets development and will have a negative effect on such development if tax rates are excessive or tax policy is inconsistent or unfair.[166]

1. High Level of Total Taxation: If the total burden of taxes, duties, fees, fines and other contributions are perceived as excessive, as in the case in Ukraine, this will expand the shadow economy by encouraging companies to manipulate earnings, do business off books, or engage in barter transactions that are hard to value.[167] Yet, strong financial markets and efficient capital allocation require that companies provide reliable information on business finances to investors and creditors. This goal of information *transparency* is harmed by tax policies that discourage honest record-keeping and information reporting.

In addition, as discussed in Chapter Three, excessive taxes can also keep money out of the financial markets, deterring persons from depositing money with banks or investing with other financial market institutions where disclosure to the State Tax Administration (STA) could possibly result in a tax audit. Financial markets development cannot even begin, however, unless money is brought into the system.

Perhaps most obviously, if a company must pay excessive taxes this will deprive the company of working capital that could have been used for modernization and growth.

Finally, excessive taxes can make contract enforcement more difficult if companies enter into informal agreements to hide profits from the STA. For example, an official written contract might show a low profit, while the actual, informal agreement results in a high profit. Such informal agreements cannot be enforced in court and may require Mafia-type enforcement mechanisms.

2. Inconsistent Tax Policy: Inconsistency in tax policy will likewise be harmful to financial markets development. Inconsistency in Ukraine takes the form of frequent base and rate changes, numerous tax holidays and repeals of tax holidays, adoption of retroactive acts, lack of adequate transition, frequent and illogical explanatory "Letters" by the STA, inconsistent exemptions and interpretations of the law by tax inspectors, and similar actions. Stability in tax legislation and its interpretation must be the goal; yet the number of new tax laws and decrees being proposed has not decreased in recent years. Once a modern tax code is fully enacted, the Verkhovna Rada should change the tax laws only when absolutely necessary.

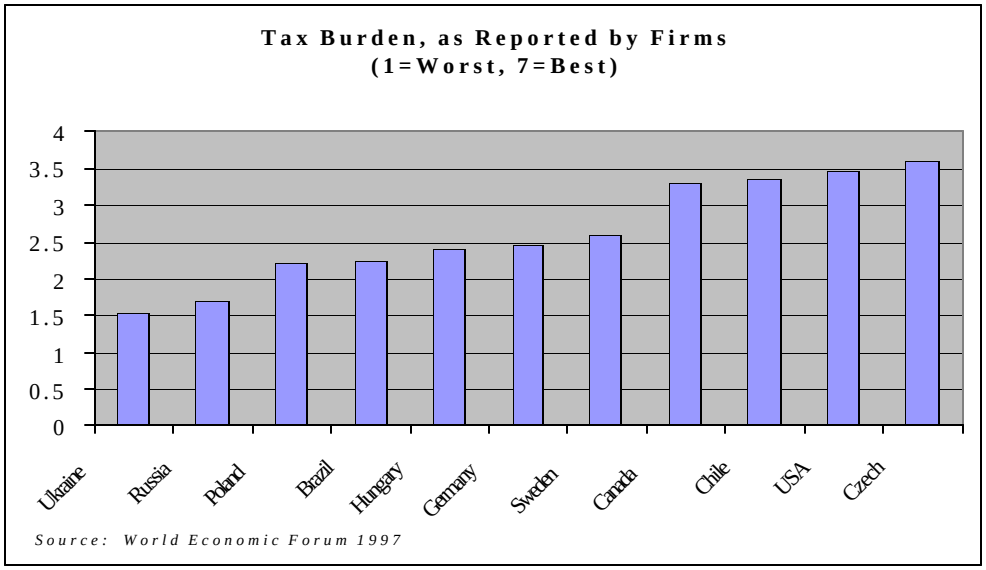
3. Unfair Tax Application: Finally, tax policy must also be fair. It is important that taxpayers be treated evenhandedly and that similarly situated taxpayers receive similar treatment by the STA (not always the case at present).

Reasons for the High Level of Total Taxation. A substantial segment of the Ukrainian economy, perhaps 50-70 percent, is unreported (shadow economy) and thus unreachable for tax purposes. It seems clear that current tax policies – most

[166] For simplicity, this Paper in places uses the term "taxes" to mean all of the taxes, duties, fees, other contributions, inspections, fines and government interventions to which entities are subject.

[167] Barter transactions reduce the amount of cash in bank accounts subject to seizure by tax inspectors.

significantly a high level of total taxation – are contributing to this harmful situation.[168] A preliminary analysis suggests that the Value-Added Tax (VAT) rate (20%) is only slightly higher than in neighboring Central European countries and the Enterprise Profit Tax (EPT) rate (30%) is about average. Overall taxes on businesses in Ukraine, however, appear to be substantially higher than in these neighboring countries because of the myriad other duties and taxes to which businesses are subject. The average small and medium-size business reported that they completed 46 tax forms in 1998, with some reporting figures as high as 300 tax forms.[169]



Part of the reason for this heavy tax pressure stems from the fact that approximately 600 agencies in Ukraine have off-budget funding – meaning that they receive funding directly from fees, duties, or taxes they themselves collect, rather than from the State budget. The result is a kind of free-for-all where every agency at both the State and local level takes care of its own funding needs without any overall coordination. And approximately 60 agencies have the right to inspect and collect fines, with many having the right to keep all or a percentage of the fines collected. Allowing agencies to keep the fines they collect is particularly harmful because it creates a "moral hazard" that they will impose inappropriate fines in order to raise revenue.

Another reason for the heavy tax burden is that – with a large number of enterprises losing money and thus not owing any taxes, other enterprises simply running up arrears by not paying taxes that they owe, and more than half of all economic activity in the shadows – the tax burden falls disproportionately on a small number of profitable, reporting enterprises.[170] Broadening the tax base would allow

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[168] The Ministry of Finance (MOF) – not the STA – is responsible for tax policy in Ukraine. In the past, the MOF had limited resources to fulfill this responsibility. Efforts are underway now to assist the MOF to build a tax policy unit that will serve as the Government of Ukraine's (GOU's) focal point for tax policy, including revenue forecasting.

[169] "The State of Small Business in Ukraine," International Finance Corporation (IFC), May 1999.

[170] In the past, revenue collection was highly decentralized and largely automatic. As a result of the break up of the old State machinery, however, Ukraine has had to struggle to set up new

reduction of the overall level of taxes (duties, fees, fines and other contributions) without reducing the amount of funds flowing to the state. In addition, tax privileges exacerbate the problem.[171] Tax privileges result in efficient, profitable enterprises being taxed to subsidize value-destroying enterprises that are wasting the country's resources.

Finally, according to the current tax accounting system, "taxable profit" is defined as the difference between gross revenues and gross costs. "Taxable profit" does not always reflect the actual economic income of an enterprise. For instance, the current system does not allow operating costs to be calculated under the last-in-first-out (LIFO) method. But in an inflationary environment, LIFO most accurately reflects the profit earned on an item of merchandise sold.[172] Even more significantly, certain large expenses, such as those connected with social assets (hospitals, sanatoriums, kindergartens, cultural centers, etc.), are not allowable in determining taxable income.

Tax Reform. Reducing the overall tax burden is obviously a difficult and complex problem. To succeed, it requires a global approach. The various agencies must begin to receive adequate funding from the national budget at the same time as their ability to raise their own funds is terminated. Redundant or unnecessary agencies should simply be closed, and the overall size of the Government reduced. The total amount of taxes that businesses are required to pay should be reduced, while simultaneously removing all tax privileges and broadening the tax base.[173] And these actions must be completed in a public and dramatic fashion.

The good news is that, starting with the budget year beginning January 1, 2000, off-budget funding will be eliminated for almost all agencies, including the STA. This is an encouraging step that demonstrates real political will to fix the problem.[174] Passing a tax code, if it happens, will be another step in the right direction. There are several draft tax codes under discussion in the Verkhovna Rada now, and we are hopeful that a good, modern code will emerge from the process. Encouragingly, at least one of the versions, reviewed by specialists contributing to this Paper, would reduce the total number of State and local taxes and duties by almost a third and

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administrative and organizational tax collection methods. Unfortunately, a "culture of tax avoidance" is now well entrenched in Ukraine, and tax arrears are a large and growing problem. Chapter Eleven of this Paper discusses the shadow economy and GOU attempts to improve collection of tax arrears. Chapter Two discusses the new bankruptcy law, which provides that all tax debts of a bankrupt debtor more than two years old are written off and the debtor is given six years to pay off tax debts from the most recent two years (Art. 36).

[171] Current privileges include allowing failing enterprises to "pay" their taxes in barter or with negotiable instruments ("veksels") and offering them various tax breaks (waivers or deferred payments of taxes and write-offs of budget loans and tax debts) and State guarantees for loans.

[172] LIFO is a method of inventory calculation that assumes merchandise is sold in the reverse order of its acquisition. Thus, cost of sales is based on recent prices, and ending inventory is valued based upon the costs of the earliest purchase made. During a period of inflation, net income is lower under LIFO than under other methods because current costs are being matched against revenue.

[173] A Senior Economic Adviser to the World Bank reported that, by World Bank estimates, tax privileges equal approximately 12 percent of GDP, close to half of total tax revenues. Thus, removing all tax privileges would allow substantial overall tax rate reductions.

[174] A new concern is that the STA receive adequate funding from the budget to perform its responsibilities as collector of revenues for Ukraine, and that other agencies losing off-budget funding also receive funds adequate to fulfill their responsibilities.

contains overall rates similar to those in Central and Western European countries. The drafts submitted to the Verkhovna Rada contain revised chapters on VAT, EPT and personal income tax; additional chapters will be added for other taxes, such as a real estate tax, sometime after passage. Rada contention is expected, but enactment of a reform tax code will greatly benefit Ukraine's economic development.

These initial reforms should be expanded and followed by a major initiative involving taxpayer education, simplified forms and instructions, and training of tax officials on the new laws and procedures. Additional steps are needed to modernize the entire revenue collection system should be modernized to lower the cost of compliance, reduce corruption and make collections more efficient.[175] For example, the STA should improve its methods for selecting taxpayers for audit and its management of tax arrears.[176] The overall goal must be to increase *voluntary* compliance in order to broaden the tax base.

Encouragingly, some progress recently has been made in addressing taxpayer requests, such as for readily available examples of properly-completed tax forms. And the STA has publicly announced that it will focus on taxpayer services and education and voluntary compliance. If the STA follows through on these public statements, this will entail a significant reform effort. Another encouraging development is the creation of the "Department for the Struggle Against Corruption" within the STA which has been active since the beginning of 1999. The Department, created pursuant to the law "On the State Tax Service in Ukraine," investigates internal corruption by STA officials and external corruption by parties trying to bribe STA officials and reports directly to the Chairman of the STA.[177]

The problem involving Soviet-style accounting – that it overstates profits and hence taxes due – may be alleviated by the current reform effort introducing new National Accounting Standards (NAS). On the other hand, the MOF is unlikely to support any tax reform that is not reasonably "tax revenue neutral." In the end, we

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[175] It is too soon to judge the recent efforts to introduce a "flat tax" for small and medium-size enterprises. Pursuant to a Presidential Decree dated June 27, 1999, individuals whose annual turnover does not exceed Hr 500,000 ($100,000) and who employ up to 10 workers, and legal entities whose annual turnover does not exceed Hr 1 million and which employ up to 50 workers, can use an expanded flat tax system. Lowering the administrative burdens on small and medium-size enterprises is a laudable goal, but policymakers must be careful to ensure that the new procedures do not create disincentives to growth (for medium sized firms that just barely qualify to use the simplified system) or increased tax fraud (by larger firms falsely claiming to qualify).

[176] The STA can improve its management of tax arrears by categorizing arrears more effectively so that it can prioritize collection. Some arrears are deemed uncollectible for political reasons because, for example, collection would result in shutting down an enterprise that is the only employer in a small town. Some arrears are old and stale and therefore are unlikely to be collectable. Some arrears are small and thus collecting them would not be an efficient use of resources. These types of arrears should be categorized in such a way that excessive collection efforts are not wasted on them.

On the other hand, some arrears are recent and thus more likely to be collected. Some arrears are large and thus collecting them would be an efficient use of resources. Collection efforts should be focused on these types of arrears. Collection efforts should be the greatest, of course, when arrears combine these two attributes - e.g., a large enterprise that pays $20,000 per month in taxes and is now 3 days late. This process of categorizing and prioritizing is not difficult - it does not even necessarily require a computer - but the STA's collection efforts are not currently structured this way.

[177] The fact that this Department reports directly to the Chairman of the STA is a great achievement, although it would be even better if the Department reported directly to the Prosecutors Office.

hope that the MOF and EPT law will allow use of NAS to the extent possible. The greater the extent to which the new accounting standards are allowed for tax purposes, the less complex will be the adjustment from a company's financial statements to its tax return. This, in turn, will reduce the burden on small and medium-size enterprises. In fact, the STA should develop a new enterprise profit tax form whose structure reflects the new NAS financial statements, which would further simplify the adjustment to taxable income. The STA has already shown a willingness to support the transition by having officials from all oblasts receive training in international accounting standards and pass on information to their colleagues. However, further developments will await the actual adoption of NAS.

The problem of large expenses connected with social assets not being allowable in determining taxable income should also be diminishing over time because many enterprise social assets are either being phased out or transferred to local governments to administer.

Taxation of Financial Markets Transactions and Services. The points outlined in this Chapter, that financial markets development will be inhibited by high tax rates or tax policies that are not consistent and fair, apply doubly with respect to taxes on financial markets transactions and services themselves. It is important that tax policy not create distortions or inhibit development of financial markets, or encourage further movement of financial markets offshore. For example, the history of international financial markets clearly demonstrates that if income taxes on capital gains and dividends, and profit repatriation tax on non-residents are too high, clearing and settlement of most securities transactions will occur offshore. Offshore trading, however, cannot be monitored by the SSMSC or taxed by the STA, and inhibits current efforts to build an adequate clearing and settlement depository in Ukraine. In general, taxes on financial markets transactions and services should remain very low, especially while the financial markets are developing.

In general, policymakers in Ukraine appear to understand that high taxation of financial markets transactions and services will only inhibit financial markets development and do little to raise revenues. For example, transactions involving securities or commercial loans are exempt from VAT. Moreover, there have been some laudable steps taken recently to resolve taxation problems in the financial markets. The most significant step was recent passage of the Law of Ukraine "On Introduction of Amendments to Particular Laws of Ukraine in order to Stimulate Investment Activity," dated July 15, 1999, which introduced amendments to the VAT and EPT laws and resolved a number of problems.[178] This was a very positive step; nonetheless problems involving taxation of the financial markets remain, including:

1. Pursuant to the EPT law, when legal entities purchase shares in an initial offering, they can only deduct the nominal value as an expense, but when they sell the shares, the full sale price must be reported as income (Art. 5.3.7 EPT law). Literally, the law states that an enterprise shall not include as an expense any

[178] For example, previously the VAT law exempted broker-dealer services conducted on a stock exchange from the tax, but omitted to exempt services conducted on an electronic stock market (such as PFTS). The July 1999 amendments fixed this problem (Art. 3.2.7 VAT Law). The July 1999 amendments also amended the EPT law so that issuers of bonds do not pay a (30 percent) tax on the proceeds from a bond issuance, as previously (Art. 7.9.1 EPT Law). This change may finally open up the possibility of developing the corporate bond market in Ukraine. In addition, the July 1999 amendments lowered the tax on dividends paid to non-residents from 30 to 15 percent (Art. 13.7 EPT Law). And, the July 1999 amendments amended the EPT law so that now investment companies and funds do not pay a (30 percent) tax on the proceeds from issuing investment certificates (Art. 7.9.1 EPT Law).

payment made to the additional paid-in capital of an issuer. This rule causes problems and should be changed because shares are often sold for greater than nominal value in initial offerings and it is important not to inhibit this pricing flexibility.

2. According to the VAT law, a person that imports property into Ukraine must pay VAT (Art. 3.1.2 VAT law), except on amounts contributed to the statutory fund of a legal entity (Art. 3.2.8 VAT law). Thus, when a foreign investor imports property to invest in a legal entity set up in Ukraine, only that part "contributed to the statutory fund" is exempt from VAT. If the nominal value of the shares issued to the foreign investor is lower than value of the imported property, the difference becomes "additional paid-in capital" of the legal entity, and this amount is not exempt from VAT. We see no possible policy reason for this result and thus recommend that the rule be changed. There are legitimate reasons why a legal entity might choose to issue shares for greater than their nominal value. For example, if the legal entity is in the process of formation, founders may not want to set a high nominal value for shares if the law allows additional paid-in capital to be withdrawn from a company more easily than statutory capital, or provides creditors with certain remedies in the event that net assets fall below the level of the statutory fund.[179] If the legal entity has an operating history, on the other hand, its value, and hence the value of its shares, may simply have grown beyond the value of the statutory fund.

We suspect that the problems described (one and two above) are inadvertent, reflecting not considered policy judgments, but rather continuing confusion in Ukraine about the role of the statutory fund and nominal value of shares. (Box 9.1)

3. Pursuant to the COM Decree "On Personal Income Tax," dated December 26, 1992, income of natural persons on *registered* savings certificates is exempt from taxation. Income on *bearer* savings certificates is not exempt. This illogical result inhibits the development of bearer savings certificates. It appears that there is no legitimate policy reason for this disparity and therefore the rule should be changed.[180]

4. The situation is unclear regarding what happens when an issuer increases its statutory fund through indexation and exchanges its outstanding shares for shares with a higher nominal value. The law does not directly address this issue. Tax authorities often insist that the balance between the old and new nominal values be included in a shareholder's gross income.[181] Including the balance in a shareholder's gross income, however, can force the shareholder to prematurely sell shares to raise money (or create losses) to cover the tax. We recommend that the tax authorities instead tax shareholders only when they sell the shares.

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[179] Both are true of the draft law "On Joint Stock Companies," and the laws of many countries.

[180] The issuing bank withholds taxes due when it makes interest payments so it is not the case that bearer savings certificates allow tax evasion (as in the United States where bearer debt instruments are now illegal).

[181] STA Letters July 15, 1998, No. 679/08/15-2211; May 08, 1998, No. 432/08/15-2211; and August 8, 1997, No. 15-0216/11-2084.

Box 9.1

Confusion about Nominal Value of Shares and the Role of a Company's "Statutory Fund"

A company's statutory fund (or "statutory capital") is equal to the nominal value of all of the company's shares outstanding. If shares are sold for greater than nominal value, the additional amount becomes "additional paid-in capital" of the company. Both the statutory fund and additional paid-in capital are historical figures having little to due with the current value of a company.

In Europe generally, a company's statutory fund is essentially a creditor protection device. The statutory fund protects creditors in two ways. First, when a company is newly formed, a Government body requires proof that the money and property forming the statutory fund are in fact transferred to the company. Creditors can thus rely on the fact that, at least initially, that level of assets was available to the company. More importantly, legal norms forbid a company whose net assets are below the level of its statutory fund from distributing money or property to the company's owners in the form of dividends or by way of the company acquiring its shares (share buy-backs are a benefit to shareholders and so are subject to the same restrictions as dividends). Thus, a creditor can make a loan decision, in part, based on the knowledge that the borrower can legally make distributions to its owners only with assets over and above the level of the statutory fund.

A company can raise its statutory fund by capitalizing profits (or to reflect asset values inflated through indexation). When a firm capitalizes profits, it makes a balance sheet adjustment increasing the statutory fund and decreasing retained earnings. In the European tradition, the purpose of such an adjustment is simply to signal creditors that they can now rely on the fact that this new, higher level of assets will remain in the firm, not subject to distribution to shareholders.

Borrowing from the European tradition, the statutory fund plays an important role in Ukraine. But that role is not always well understood and is sometimes exaggerated, causing problems such as those involving taxation outlined in the text.* Laws and regulations that are based on the level of a firm's statutory fund rather than on a more accurate measure of a firm's current value, or that treat amounts contributed to the statutory fund differently from amounts contributed to additional paid-in capital, reflect either a fundamental misunderstanding about the role of the statutory fund and nominal value of shares, or a belief that the net asset value or book value of a company or the market value of its shares – any of which *should* be a more accurate measure of a company's current worth – are impossibly suspect in a transition economy. Whatever the case, such legislative norms cause distortions and problems in the financial markets and lawmakers should correct these problems and take care to avoid them in future laws.

* Events surrounding Zhitomiroblenergo demonstrate the confusion surrounding the concept of the statutory fund in Ukraine. Zhitomiroblenergo is a large energy company that recognized certain power transmission lines as assets on its balance sheet, even though they "had not been privatized." The "non-privatized" assets appeared on the asset side of the balance sheet (without an explanatory footnote as to their "special status"), with a matching entry in the shareholders' equity portion of the balance sheet as "other capital" (account 88). The assets were not included, however, in the company's statutory fund (account 85). Social assets such as kindergartens or clinics are often treated in this fashion. The Government decided that it would "privatize" these assets, transfer them to the company's statutory fund, and issue shares to itself for the value of the assets. This result – nonsensical under international accounting standards – diluted other shareholders' interests. These shareholders, to the extent they knew that assets on the balance sheet had not been privatized, reasonably expected that the company would have the continued use of these assets. Thus, the "privatization" of the assets only marginally increased the value of the company, if at all.

5. When natural persons sell securities to legal entities, the entities are required to deduct a percentage of the sale price pursuant to the procedures for taxation of employee income (even if the seller is not an employee of the legal entity).[182] This odd result distorts the proper functioning of the financial markets and should be changed.

6. Investment companies and funds often have trouble meeting the conditions required to avoid double taxation. The EPT law provides that an investment company or fund does not pay EPT on its investment returns if: i) it pays out at least 90 percent of its investment returns to investors within 30 days of submission of its annual report; and ii) none of the founders or participants owns more than 25 percent of the statutory capital of the investment company or fund (Art. 4.2.8 EPT Law).[183] The EPT law is in keeping with international practice – all countries have tight distribution and ownership rules that must be met before an investment company or fund can avoid taxation on its investment income (so called "pass-through tax treatment"). But investment companies and funds in Ukraine complain that their expenses often exceed ten percent of their investment proceeds and thus they cannot distribute 90 percent to investors. We do not recommend that the law be changed, however, as fund expenses equaling more than 10 percent of investment proceeds are extremely high by international standards. Rather, efforts may be needed to help investment companies and funds find ways to bring down their expenses.

[182] COM Decree "On Personal Income Tax," December 26, 1992.

[183] The July 1999 amendments to the EPT law raised this ownership limitation from 10 percent to 25 percent, presumably to make the conditions easier to meet.

Action Points:

- **Reduce the total fiscal burden on enterprises by reducing the number of taxes, duties, fees, fines and other contributions to which enterprises are subject. Broaden the tax base by eliminating tax privileges and improving tax collection (in cash, not in barter or negotiable instruments ("veksels"));**

- **Reduce the current inconsistency in tax policy and increase the fairness of tax application;**

- **Disallow all agencies from keeping any part of fines they collect, and consider reducing the total number of agencies that have the right to inspect and collect fines;**

- **Improve, resubmit and pass the draft tax code;**

- **After passage of the tax code, publicly and dramatically begin a major initiative involving taxpayer education, simplified forms and instructions, and training of tax officials on the new law and procedures.**

- **Encourage the STA to expedite its current efforts: (i) to modernize its revenue collection system to lower the cost of compliance, reduce corruption and make collections more efficient; (ii) to improve its methods for selecting taxpayers for audit; and (iii) to strengthen its management of tax arrears by categorizing arrears more effectively in order to prioritize collection;**

- **Facilitate use of the new National Accounting Standards (NAS) for tax purposes to the extent possible, thereby reducing the complexity of the adjustment from a company's financial statements to its tax return. Develop a new enterprise profit tax form whose structure reflects the new NAS financial statements;**

- **Follow up on the initial training already provided to STA officials in international accounting standards;**

- **Consider reducing further taxes on financial markets transactions and services so that taxes do not create distortions, inhibit development of financial markets, or encourage further movement of financial markets offshore. Address the six specific problems outlined in the text involving taxation on the financial markets; and**

- **Clear up the general confusion surrounding the concept of a company's statutory fund, and ensure that laws and regulations do not treat amounts contributed to the statutory fund differently from amounts contributed to "additional paid-in capital" absent a valid policy reason.**

10. Contract Enforcement

Financial markets development requires that the participants have a *confident expectation* that transactions will be completed. This requires reliable mechanisms for contract enforcement.[184] Banks enter into contracts with borrowers, not just to bind the borrower to a certain interest rate and repayment period but often to impose conditions to ensure that the borrower will be able to make timely repayments (such as restrictions on the removal of collateral, or requirements that collateral be insured). Securities markets depend upon reliable purchase and sale agreements in both the primary and secondary markets as well as contracts between market professionals and their clients. And in the productive sector that is served by the financial markets, contracts are the bedrock of commercial activity. In short, there can be no financial markets development without an adequate contracting regime. It is imperative that contracts are not breached with regularity, and that compensatory remedies are promptly available if they are. More broadly, it is important that behavioral rules are consistent with marketplace needs, and that business practices are enforced through established, known, and reliable procedures.

Failure to honor contracts is one of the most widespread complaints about the local business climate.[185] In the absence of adequate, legal contract enforcement mechanisms, Mafia-type enforcement mechanisms flourish. In addition, businesses tend to enter into transactions only within a small circle of those they know and trust. These factors limit overall commercial activity and have deleterious impact on financial markets development. As described in Chapter One of this Paper, the high profile instances of altering or voiding major contractual agreements with foreign businesses seeking to invest or trade in Ukraine – with little or no adverse consequences for the breaching party – have been perhaps the most harmful to overall financial markets development. The high visibility of these breaches has done serious damage to investors' *confident expectations* that agreed-upon transactions will be completed.

Interestingly, it appears that Ukraine's foreign arbitration laws and laws on its domestic courts are comprehensive and in accordance with world standards.[186] Most importantly for foreign investors, the Ukrainian laws provide that the parties to an international agreement have the freedom to select either the domestic (Ukrainian)

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[184] Broadly speaking, contracts are enforced through three mechanisms: courts (formal enforcement), reputational mechanisms (informal enforcement), and self-help mechanisms incorporated into the contract (party enforcement). The first two do not work particularly well in a transition economy such as Ukraine's; therefore, contractual self-help mechanisms are vital. This chapter of the Paper focuses on the need for self-help mechanisms and the current state of the court system, but it is important to keep in mind that the third mechanism, reputational enforcement, is also lacking in Ukraine. Most businesses have not yet developed significant "reputational capital" to worry about the risk of damaging it if they breach a contract.

[185] Enterprise arrears are equal to approximately 85 percent of GDP, up from 65 percent in 1996. This is a great deal higher than in a typical, well-functioning market economy.

[186] These include the code "Of Arbitration Procedure," November 6, 1991, and the laws: "On Arbitration Courts," June 21, 1991; "On International Commercial Arbitration," February 24, 1994; "On Foreign Economic Activities," April 16, 1991, # 959-XII; and "On Foreign Investment," March 13, 1992, #2198-XII, as amended by COM Decree #55-93, dated May 20 and effective June 5, 1993. The law "On the Regime of Foreign Investing," March 19, 1996, replaced the Law "On Foreign Investment," and the Decree that amended it, although foreign investors that invested when the Law or Decree were effective can still apply to receive the protections that were provided in the Law or Decree.

court system or international arbitration in any other country (including Ukraine). Further, Ukraine has established a forum for international commercial disputes at the Ukrainian Chamber of Commerce and Industry by following rules put forth by the United Nations Commission on International Trade Law (UNCITRAL).[187]

Thus, it appears that the problem in Ukraine is neither lack of legislation nor lack of familiarity with international standards, but rather that the law is so routinely ignored, and that practical execution and enforcement of the law is so difficult. Historical and cultural factors have converged to undermine the rule of law, including protection for parties who have suffered losses from breach of contract. During the Soviet era, almost all legal entities were owned by the Government and contract-based relations among legal entities were colored by this fact. Central planners required enterprises to enter into certain contracts, and the Government played a role in enforcing the terms of the bargain. The view was fostered that contracts were no longer binding in the event of "changed circumstances." This legacy still thrives in Ukraine, and Government interference in contracts still occurs.

Another problem is the lack of a credible threat of bankruptcy, usually one of the most effective ways of enforcing contracts. Managers and directors must feel that, if they fail to honor contracts for delivery and payment, the other party could force the company into bankruptcy and they could lose their job and/or their ownership interest in the company. The new law "On the Restoration of Solvency of the Debtor or Declaring it Bankrupt" should improve the situation, but real improvement will also require improving the institutional framework required to handle a large number of bankruptcy cases. Once a credible threat of bankruptcy exists, voluntary performance of contracts (without filing a bankruptcy petition) should increase.

Pre-contract Due Diligence. Parties entering into contracts in Ukraine often find that problems arise at the earliest stages because of the difficulty of confirming information about the other party to the contract. This difficulty in performing pre-contract "due diligence" makes it difficult to lay the proper foundation for a contract. In part, this is due to an absence of public registries. For example, there is no real property registry of title.[188] There is also no registry of bankruptcy cases; a person performing due diligence must review the bankruptcy notices in every issue of the *Uryadovy Kuryer* for the last six months. Encouragingly, the new bankruptcy law calls for the creation of a registry of enterprises against which bankruptcy proceedings have been initiated.[189] As another example, the "Unified State Registry of Enterprises and Organizations," maintained by the State Committee of Statistics, provides information about registration of legal entities throughout Ukraine, but this information is gathered from local authorities in a haphazard fashion and cannot be relied upon. The State Committee of Statistics does not itself register legal entities and so the list it maintains is not definitive. Encouragingly, the Cabinet of Ministers (COM) recently passed Resolution No. 2103, dated November 18, 1999, "On the Registry of Subjects of Entrepreneurial Activity," which calls for the Licensing Chamber to create and maintain a registry of subjects of entrepreneurial activity that will be open to the public

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[187] It is reported, however, that the Ukrainian Chamber of Commerce and Industry is staffed by personnel largely committed to Soviet-era thinking who are strongly biased against foreign parties.

[188] There is a mortgage registry, but no general registry of title to real property. Some title information regarding private housing can be obtained from Local Housing Authorities, but it is not complete and not available to the public.

[189] Article 2.2 of the Law of Ukraine "On the Restoration of Solvency of the Debtor or Declaring it Bankrupt."

for a fee.[190] If this resolution results in the creation of a unified, reliable database of all legal entities in Ukraine, it will make pre-contract due diligence somewhat easier and enhance the business environment in Ukraine.[191]

Even if the requisite public registries are initiated, however, it will still be difficult to get a true picture of the other party to a contract. For example, companies commonly keep two sets of books in order to hide the true value of transactions and salaries, and engage in barter transactions that are hard to value accurately, making financial information about a company suspect.

Obtaining tax records from the other contracting party provides only moderate comfort because one cannot be certain that the records have not been altered, and because under-reporting for tax purposes is common. We recommend that the State Tax Administration (STA) consider instituting a procedure whereby it would provide tax records directly to a third party, upon instruction of the taxpayer, in order to increase the reliability of the records. The STA could charge a fee that would cover search, copying and mailing costs. The STA should support this idea because it would encourage more honest reporting in tax returns and increased consistency between tax returns and financial statements.

Court Decisions. If a contract dispute ends up in court in Ukraine, it is extremely difficult to predict how the matter will be decided. Consequently, there is no way to know how written laws will be interpreted in fact. This lack of predictability is one of the biggest problems contracting parties face in Ukraine.[192] The laws are vague, often contradictory, and the courts do not have a body of precedent to guide their decisions.[193] The lack of precedent results not just from the fact that most laws are newly-passed, but also from the lack of a system for publishing court decisions. This gives judges wide latitude, which opens up greater possibilities for bribes and other forms of influence. Moreover, proving a case can be difficult because courts respect only documentary evidence which is often not available given limited discovery.[194] In addition, most judges are poorly paid and not prepared by education

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[190] The new Registry will have three levels: i) a central database created by the Licensing Chamber on the basis of regional databases; ii) regional databases created by the Licensing Chamber's representative offices on the basis of territorial databases; and iii) territorial databases created by local authorities (i.e., created by "the bodies of State registration of entrepreneurial activity"). Presidential Decree No. 1573/99, dated December 12, 1999, provides that the Licensing Chamber is to be liquidated and its functions transferred to a new "State non-profit institution (agency)."

[191] The version of the draft civil code that passed its first reading calls for the bodies of the Ministry of Justice to register all legal entities in Ukraine and maintain one definitive list of legal entities.

[192] In the United States, corporations often locate in the State of Delaware in part because the outcomes of cases in this state are predictable due to the vast number of cases previously decided and the resultant extensive body of precedent. Predictability and confident expectations in legal outcomes are crucial for businesses because this allows them to plan for contingencies. Investors too are sensitive to unpredictability resulting from unclear legal situations and will demand a high premium to cover this increased risk, or refuse to invest at all.

[193] Ukrainian courts are not bound by *stare decisis*, the common law doctrine that a court must follow decisions of previous cases in the same jurisdiction with similar fact patterns, but nonetheless do draw guidance from previous cases.

[194] We use the term "discovery" as a general term for various mechanisms used to obtain facts and information about a case. Such mechanisms can include the power to enter land or premises to search for evidence, require mental or physical examinations of persons, or require that the parties to the case or a third party: i) orally answer questions on the record under oath (testimony); ii) answer

or experience to decide complex commercial cases. They focus on resolving the conflict rather than enforcing the bargain, to the detriment of the party that would have benefited had the contract been honored as written.

The problem is further complicated by the legacy of the Soviet era when the courts were operated as direct instruments of State power. Judges routinely received telephone calls from Government officials directing the outcome of a case. The process of moving from this system of "telephone justice" to a fully independent judiciary that actually serves as a check on the executive branch's discretionary power is not yet complete. Thus, the need is strong for more precise laws and education of judges on market-driven commercial practices and on the role of a modern, independent judiciary.

> *The law will not work unless the Government is respected, and the Government will not be respected unless the law works.*
>
> Anthony Kennedy

The prosecutors office (Prokuratura), a highly political body surviving from the Soviet era, periodically involves itself in civil cases and pressures courts to reverse their decisions. Public prosecutors also play a role in ordinary civil cases in Western European countries (except Germany), where they can intervene to represent the "interests of society." The role of the Prokuratura under the socialist law tradition, however, was considerably more pervasive and intrusive than the role played by a public prosecutor in a Western European country. The role of the Prokuratura in Ukraine should be re-examined to ensure that it is in line with the European civil law tradition.

Finally, access to the judicial system is hindered by high cost barriers. For example, the filing fee in arbitration court, five percent of the damages sought, is a significant deterrent to using the courts.[195] A plaintiff must initially transfer the filing fee in full to the State budget. If the plaintiff is successful, the court will often require the defendant to reimburse the plaintiff for the filing fee, but generally without interest – a serious problem in a high-inflation environment.[196] Encouragingly, the law "On

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questions in writing under oath; or iii) produce documents or things (physical evidence). In common law countries, it is generally the parties themselves that have these powers and that conduct "discovery" in advance of a trial. In civil law countries, the process is somewhat different– the judge generally plays a more active role in overseeing the gathering of evidence and taking testimony during a series of hearings (there is often no one-time, comprehensive "trial"). In Ukraine and other formerly-socialist countries, well-developed, effective mechanisms for gathering evidence about a case do not exist. Under the socialist system, a civil plaintiff had only a few informal methods he could use to uncover the facts of a case. Complex commercial litigation in a market economy, however, requires the development of more formal, powerful tools for discovering evidence.

[195] Some plaintiffs have involved the Prokuratura in cases in order to avoid the filing fee, although this practice is on the decline because the new Constitution restricts the right of the Prokuratura to go to court in the interests of third parties.

[196] An even more significant inflation-related problem, until recently, was that a creditor in Ukraine who failed to stipulate in the contract an interest rate to be paid on amounts overdue faced the prospect of significant losses to inflation. This was because Civil Code Article 214 stated that "a debtor who is in default on his financial obligation shall pay interest at the rate of three percent annually on the overdue amount for the entire delay period, unless the law or the contract stipulates otherwise." Thus, during 1992-94, creditors frequently received three percent on overdue amounts when inflation exceeded 100 percent per month. The Supreme Court issued Letter No. 62-97 on April 3, 1997, which recommended that courts index for inflation when calculating amounts owing, but this letter was only a recommendation and was often not followed. The problem was finally fixed in 1999– Article 214 of the Civil Code was amended to specify that overdue debt must be repaid in an amount increased by the inflation index. This is a positive development which will make it less profitable to

Making Changes to the Cabinet of Ministers Decree on State Duty," adopted November 18, 1999, will lower the filing fee to one percent starting January 1, 2000.

Enforcement of Judgments. Execution of judgments is also a problem in Ukraine. Arbitration courts must transfer judgments to the Court Executor of the general courts for execution. Losing litigants are frequently able to hide their assets, either before or after judgment. On the one hand, a prevailing party is generally able to reach money in the losing party's bank account because the banking system is tightly controlled. Prevailing parties are given an order allowing them to access funds in such accounts (if the funds have not been removed first). On the other hand, however, efforts to attach other property require the involvement of the Court Executor and are generally much less successful. Although the Court Executor can seize property and can order Government officials to comply with judgments, it is hampered by low pay, no public respect of court decisions, no enforcement mechanism (e.g., it cannot subpoena someone to ask where assets are hidden), and a cash economy.

Judgments that fail to result in recovery provide no remedy and, indeed, discourage even pursuing a judicial recovery process.

Self Help Mechanisms. The use of "self-help" clauses in contracts can be an effective way to ensure that a remedy is available for breach of contract without having to resort to the court system. The new law "On Pledge" specifically allows contracting parties to agree on self-help mechanisms. Parties can agree on certain foreseeable events that would constitute breach of a contract and provide for self-help seizure of property upon occurrence of such event. For example, a loan agreement between a bank and a collective agricultural enterprise might specify that, if interest is not paid by a certain date, the bank can come and take possession of a plow, and if the principal is not repaid, the bank can take possession of a combine (all without involving any third party).

Parties also can place property in trust or escrow to guarantee performance of a contract – the trustee or escrow agent will release the property to the injured party upon breach of contract – although the legal bases for these mechanisms are not well developed.

A letter of credit issued by a bank can also be used to provide a guarantee of performance. To protect themselves, sellers can refuse to deliver goods until receiving either pre-payment or a letter of credit from the buyer. Buyers, on the other hand, can protect themselves by declining to pre-pay and "paying" instead by letter of credit that conditions payment by the issuing bank on performance by the seller.

Finally, parties to a contract can agree that, if there is a dispute, a specified third party will resolve the matter. This third party could be a professional arbiter, but could also simply be any respected, mutually agreed-upon neutral party.[197]

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be a debtor in Ukraine. It will also tend to increase the number of enterprises against which creditors have "indisputable claims" equal to at least 300 minimum wages – the test to initiate a bankruptcy proceeding under the new bankruptcy law – but this may also be a positive development as we are hopeful that the new bankruptcy law will be an effective vehicle for enterprise restructuring.

[197] PFTS, the association of securities traders that owns and operates the primary electronic stock market in Ukraine, provides a good example of the use of out-of-court arbitration procedures to resolve commercial disputes. PFTS received SRO status from the SSMSC on December 31, 1997. One of the functions of an SRO is to resolve disputes between members, and between members and their customers. Consequently, PFTS adopted an arbitration code pursuant to which arbitration panels

The point is that parties to an agreement should find creative ways to craft adequate self-help remedies that will keep them out of the court system entirely. Education of business people is needed to make them aware of the possibilities.

The Draft Civil Code and Draft Economic (Commercial) Code. Legal norms governing contracts in Ukraine are contained in the Civil Code, which dates back to 1963. A new, modern civil code, is desperately needed to improve the legal environment for parties contracting in Ukraine. Currently, the legal community in the country is divided between the drafters of the Civil Code, who want to adopt a comprehensive civil code that will include provisions related to business entities and commercial transactions, and those that want to adopt a separate "Economic (Commercial) Code of Ukraine" (economic code) to regulate business entities and commercial transactions. Having reviewed the draft economic code, it is clear to us that the draft is based on an assumption that the State should have a leading role in the economy. It contains norms which prevailed during central planning, such as the obligation of enterprises to fulfill State orders and administrative decisions (as opposed to the enterprises' own market-based decisions and private contracts). Pursuant to the draft, State bodies are charged with developing "plans" that will confine competition within the frames of public utility.[198] In sum, the draft economic code would substantially hinder market reforms, and thus we urge the Verkhovna Rada to reject the draft.[199]

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hold hearings to consider evidence and resolve disputes involving PFTS members. Decisions are binding, but may be appealed to the arbitration court. Approximately 30 cases have been heard to date, and the claimant was successful in approximately half of those cases.

[198] For example, Article 3 of the draft economic code states that the basis of "social business orderliness" shall be legal norms and social and economic decisions (plans, programs, balances of resources, etc.) adopted on behalf of society by State bodies to effectively combine private and social interests and provide for a stable business environment. State bodies are tasked with organizing fulfillment of the requirements of "social business orderliness." Article 8 states that enterprises, in their commercial and non-commercial activities, shall take into account the objectives, priorities and overall social orientation of general business programs (plans). Article 14 states that enterprises shall respect the directions of social and economic development established by the "plans" and conform their activities with them. Finally, we note in general that the draft does not appear to represent deep thinking regarding what legal rules would help Ukraine's economy recover. In fact, many provisions simply duplicate word-for-word outdated norms of existing laws such as the current civil code, and the laws "On Business Associations," "On Investment Activities," "On Securities and the Stock Exchange," "On Taxation of Enterprises' Profits."

[199] The Ukrainian-European Policy and Legal Advice Centre (UEPLAC), the primary specialists of the European Union's Tacis program in Ukraine in the area of legislative development, reviewed the draft civil and economic codes in detail in a paper prepared by Dr. Achim Schramm and Marina Podpalova dated August 4, 1999. Their recommendation is that the Verkhovna Rada pass the civil code first, then decide later what special (private) commercial provisions are still needed. At that point, lawmakers can decide whether these additional provisions should be added to the civil code, collected in a special (private law) commercial code, or left to individual laws on specific topics. Schramm and Podpalova distinguished those parts of the draft economic code related solely to public commercial law, on which, they suggested, it is appropriate to continue work simultaneously with work on the draft civil code.

Action Points:

- **Initiate a registry of enterprises against which bankruptcy proceedings have been initiated, as called for in the new bankruptcy law;**

- **Create and maintain a unified, reliable, publicly accessible registry of all legal entities and other subjects of entrepreneurial activity in Ukraine, as called for in Cabinet of Ministers (COM) Resolution No. 2103, dated November 18, 1999;**

- **Consider provision by the STA of tax records for a fee directly to third parties conducting due diligence, upon instruction of the taxpayer, in order to increase the reliability of such records;**

- **Develop a comprehensive system for publishing court decisions and making them widely-available to lawyers and judges;**

- **Consider modifying the rules of civil procedure to introduce more extensive tools for discovering and presenting evidence about a case, as required in complex commercial litigation;**

- **Provide training for judicial personnel on market based transactions and on the role of a modern, independent judiciary that serves as a check on the executive branch's discretionary power;**

- **Draft more precise laws to give judges more guidance and limit the latitude they have in crafting their decisions;**

- **Re-examine the role of the Prokuratura in Ukraine to ensure that it is in line with the European civil law tradition;**

- **Expand the powers and effectiveness of the Court Executor to implement execution of judgments;**

- **Educate business people on the use of "self-help mechanisms" that do not require judicial enforcement, such as clauses in contracts that provide for "self-help" seizure of property upon breach of contract; use of letters of credit and trustees or escrow agents to guarantee performance; and resolution of disputes by pre-selected third parties; and**

- **Finalize and pass the new civil code and reject the draft economic (commercial) code with its State-oriented bias.**

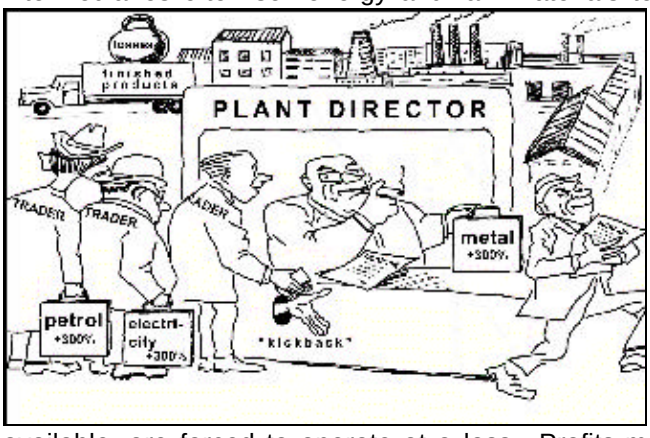
11. Increasing Investment by Restructuring Production Costs: Commodity Exchanges, Barter, Veksels, Corruption and the Shadow Economy

This Paper focuses on developing efficient financial markets. In essence, the proposals in this Paper are all designed in one way or another to reduce the cost of capital. But the cost of capital is only one cost faced by an enterprise. Other important costs include labor, energy, raw materials, and Government services (paid for through taxes). Policies to reduce these other costs are also necessary to increase investment in Ukraine. Investors, after all, seek high returns and low risk – and returns are higher when costs are low. Thus, this chapter examines an important strategy to increase investment: removing distortions that artificially inflate the cost of critical production inputs such as energy and raw materials.

Reforms to bring the costs of production down to market levels are an effective and sustainable strategy, superior to "quick fix" policies designed to make a country more attractive for investors such as tax privileges, subsidies to investors, loan guarantees, and so on. These "quick fix" benefits are a drain on the budget and can actually make the investment climate worse because they are not sustainable and can be taken away as easily as they are given.

Domestic Production Inputs. Domestic production inputs in Ukraine are artificially overpriced. In some cases, this is the result of Government policies – e.g., enterprises commonly pay more than the market cost for energy as a result of Government efforts to cross-subsidize households. In other cases, it is the result of the non-payments crisis – those that pay subsidize those that do not pay – or the widespread use of "money surrogates" such as barter and negotiable instruments ("veksels") that increase transactions costs. In still other cases, it is the result of market imperfections: the market for production inputs in Ukraine is inefficient and non-transparent. Under the command economy, State-owned enterprises were provided with energy, raw materials and financial resources by a multidivisional centralized infrastructure, namely Gosplan (State Planning Department), Gossnab (State Supplying Department), and the MOF (Ministry of Finance). In part, the current inflated cost of production inputs in Ukraine is caused by the fact that efficient and transparent mechanisms performing similar functions on a market basis do not yet exist.

Worse yet, the players have developed various schemes to take advantage of the inefficiency and non-transparency of the market. For example, trader intermediaries often sell energy and raw materials to enterprises at artificially high prices, sometimes sharing some of their "super-profits" with enterprise managers. Mark-ups can be between 100 - 300 percent, versus 10 percent or less in Western economies. Enterprises cannot switch to cheaper, better-quality raw materials from the West due to a lack of cash. Enterprises with such high costs, selling into a market in which cheap imported goods are also available, are forced to operate at a loss. Profits move from the State into private hands – when the schemes involve State-owned enterprises, which is most often the



case – or from shareholders and creditors into private hands – when the schemes involve privatized companies.

The existence of this widespread corruption is one reason for the common sight of managers at loss-making enterprises arriving to work in new Mercedes. Some of the gains from this system are believed to be shared with Government officials, who facilitate the transfers or "look the other way," assuring the officials' interest in maintaining the system.

Such corruption partly explains why enterprises or divisions that are operating at a loss are not simply shut down. Other reasons include: i) the fact that the managers worked for years under a system where success was measured by the amount of goods shipped, not profitability; ii) the need for enterprises to sell goods, even at a loss, to raise cash to pay salaries; iii) the desire to remain in operation to preserve jobs; iv) the enterprises' ability to obtain inputs using barter, veksels and other non-money forms of settlement and thus avoid hard budget constraints; and, v) the absence of broad implementation of effective bankruptcy mechanisms.

There are many other schemes involving intermediaries, the aim of which is usually both tax evasion and profit skimming. For example, a steel producer selling to a machine-building enterprise might first set up a temporary company, sell steel to that company at a five percent mark-up so that the steel producer's tax liability is limited, and then direct the company to sell to the machine-building enterprise at a huge mark-up. The temporary company incurs a substantial tax liability, but is simply liquidated before the taxes are due. The director of the machine-building enterprise might be bribed to take part in the scheme. Another variation involves using an offshore company rather than a temporary Ukrainian company.

Many of the schemes are innovatively complex. The players go to great lengths to design schemes that take advantage of loopholes in the law or weaknesses in enforcement of the law. The result is a kind of carefully orchestrated chaos throughout the economy, which institutionalizes corruption. In the end, these pervasive schemes do great harm by robbing the budget of tax revenues and stealing profits from the owners of the participating enterprises — either the State or private shareholders.[200]

Reduce the Cost of Domestically-Produced Production Inputs. Reducing the cost of domestically-produced production inputs will require a sustained, multi-pronged approach:

- Build market infrastructure to facilitate trading and increase efficiency and transparency;
- Further privatize the energy and raw material sectors;
- Ease the non-payment crisis;
- Reduce the use of "money surrogates";
- Reduce corruption and intermediaries' "super-profits"; and
- Advance sector-specific reforms.

[200] Although schemes using intermediaries to circumvent the system were a feature of the command economy, it appears that the explosion of such schemes since independence may have been caused by the lack of money in the economy and the rise of "money surrogates." Unfortunately, the schemes have a momentum of their own now and will be hard to eradicate. Market players have learned how to appear to be losing money and avoid taxes while getting rich.

1. Build Market Infrastructure to Facilitate Trading and Increase Efficiency and Transparency: The organized market in Ukraine for energy and raw materials is under-developed. Commodity exchanges, where they exist, are inadequate in terms of standardization, risk reduction, and the range of available services. They operate chaotically and without any coordination between exchanges.[201] Efficient commodity exchanges for metals, energy resources, and agricultural products would provide for competitive trading of these resources, leading to lower prices and more transparency.[202]

The Government of Ukraine (GOU) has recently taken steps to revive commodity exchanges by channeling all purchases for, and sales from, State reserves through certain approved exchanges.[203] These steps are to be applauded, but monitored closely. Some have voiced concerns that State bodies plan to use this mechanism to control prices and grain movements. This would be a serious mistake. Prices must be set by market forces; Government attempts at controlling prices will always result in market distortions and new problems. Exchanges increase transparency, competition and efficiency, but only if allowed to operate by market rules.[204] Moreover, trading should be attracted onto exchanges through improvements in infrastructure, rather than forced through heavy-handed requirements that all grain contracts be registered at exchanges.

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[201] Trading on organized commodity exchanges appears to be declining. For example, in 1995, three million tons of grain was sold via exchange trading, but by 1998 this figure had shrunk to 105 thousand tons. (Interview with Boris Supikhanov, ex Agro-Industrial Complex Minister and current head of the Ukrainian Grain Association, *Eastern Economist*, Vol. 6, #48, December 20, 1999).

[202] During the Soviet period, agricultural products were collected by State-run preparation centers or consumer cooperatives, and there was centralized calculation of the quantities of crops required for sale and distribution. This system is now in ruins. In a true market economy, of course, farmers adjust their production levels based on signals about supply and demand reflected in prices. Such transparency and free market environment do not exist in the Ukrainian agricultural sector, however, and consequently farmers work with inadequate information, not knowing what and how much they should grow each season.

[203] On October 19, 1999, the COM passed Resolution No. 1928 "On Activation of the Commodity Exchange Market for Agro-Industrial Complex Products and Required Material Resources." In addition to requiring that all purchases for, and sales from, State reserves be conducted through approved commodity exchanges, the Resolution also requires that deliveries of inputs and machinery to farms, using State budget funds, in exchange for future crops be conducted via such exchanges. For this purpose, the relevant ministries and agencies must develop a mechanism of so-called "reciprocal contracts," apparently a kind of standard forward barter contract. Finally, the Resolution requires the Pension Fund and STA to sell agricultural products received from agricultural producers as tax payments, or as contributions to the Pension Fund, only via the approved exchanges. It remains to be seen if these recent legal measures will work in practice.

[204] In addition, if an active market for exchange-traded futures contracts could be developed, these instruments would provide for insurance to producers against drops in prices for their products. Unlike spot or forward contracts, which are used to actually buy and sell a commodity, futures contracts are used like insurance for risk management (hedging). They very rarely result in actual delivery of the underlying commodities. Instead of delivering, or accepting delivery of, the commodities, futures traders offset their obligations by reversing their futures positions. This "price insurance" function would be helpful in Ukraine, particularly for farmers. Theoretically, harvest insurance against natural disasters does exist in Ukraine, but the premiums are so high – up to 20 percent of the insurance contract value – that no one buys such insurance.

Other elements of market infrastructure that need to be improved and expanded to lower the cost of production inputs are obvious, including communications networks, highways, bridges and railroads, energy transmission systems, and small business support centers.

2. Further Privatize the Energy and Raw Material Sectors: Proper privatization of enterprises in the energy and raw materials sectors will bring foreign investment and increased competitiveness. This, in turn, will generate higher quality production inputs at lower prices. Many of the production inputs produced in Ukraine are of low quality by international standards and this ultimately reduces the quality of finished goods. Foreign strategic investors are needed to modernize facilities, make them energy efficient, and bring them up to international standards.

Most pressingly, Ukraine must fully privatize grain elevators and storage facilities; pursue genuine privatization of farms; continue to privatize viable coal mines; complete privatization, as planned, of all four power generators and 27 oblenergos; and privatize the natural gas sector (without creating exploitative private monopolies).

3. Ease the Non-Payment Crisis: Late payment, non-payment and payment using cash substitutes are a serious problem in all of the production input sectors, resulting in increased prices for those who do pay. The culture of non-payment for electricity is particularly pernicious. Enterprises are robbed of the means to invest in expansion and modernization. Incentives are needed to improve collection rates, particularly cash payments, including disconnections and service cut-offs, formal rescheduling of arrears, a credible threat of bankruptcy, a threat of filing collection actions in court, and public awareness campaigns.

4. Reduce the Use of "Money Surrogates": Since independence, Ukraine has witnessed a startling increase in pseudo-market forms of settlement such as barter, mutual settlement of outstanding debts, and veksels. The main cause of this is the shortage of money supply in the economy caused by a combination of tight monetary policy and lax fiscal policy. The Government finances its budget deficit through various forms of borrowing that soak up what money there is in the system. Consequently, enterprises have no cash to pay their suppliers. Other causes include reluctance to use the banking system by tax payers engaged in tax evasion, because bank accounts can be blocked by the tax authorities; the ease with which managers can avoid taxes and commit fraud using these non-transparent payment mechanisms; and the general "shadowization" of the economy.

Barter contracts are very costly, particularly for firms that conclude contracts with unfamiliar partners for the first time and thus have limited information about a trading partner. The cost of concluding and negotiating the terms of most barter transactions is roughly 20 to 25 percent of the value of the transaction. To reduce this cost, enterprises use veksels, which after barter are the most common instrument used to avoid monetary settlements (Box 11.1). A veksel is a debt security issued in a commercial transaction – essentially a promise to pay a sum of money issued in a form that can easily be transferred from one person to another. Banks, enterprises and State bodies can issue veksels.[205] The actual value of a veksel depends mainly

[205] State bodies' legal right to work with veksels is an ever changing picture. In order to raise the proportion of cash payments in budget revenues, COM Resolution # 1576 of August 27, 1999, prohibited the Crimean Cabinet, oblast administrations, and Kyiv and Sevastopol city administrations from issuing, accepting, endorsing or guaranteeing veksels. These operations were previously permitted by a resolution passed in May 1999. First Vice-Premier Anatoly Kinakh recently stated,

on the reputation of the issuer and the ease with which it can be converted into cash or a useful commodity. These factors determine the discount rate on the veksel, which can be as much as 70-90 percent off the face value.

Box 11.1

How Veksels Facilitate Barter in Ukraine

In Ukraine, veksels often are used to replace barter. In a barter transaction, two parties must have goods or services that the other party desires, that are of exactly the same value, and that are available at exactly the same time. Veksels reduce the necessity for this "double coincidence of wants." Party A "pays for" a good or service buy issuing veksels to Party B; then later, when Party A has a good or service desired by Party B, Party B "pays for" this good or service by canceling some or all of the veksels. Much more commonly in Ukraine, veksels are transferred in a big circle and back to the original issuer – an electric company without cash issues veksels to a coal producer, which sells the veksels at a discount to a market intermediary, who sells the veksels on a stock exchange to a steel manufacturer, which pays it's electricity bill with the veksels – functioning just like money.

Parties in Ukraine using veksels to offset obligations to each other generally want to avoid the situation where veksels are sold to a third party and presented for payment in cash. Thus, the parties sometimes enter into contracts governing the procedure for veksel settlement that prohibit this. These contracts, however, may in fact violate the Geneva Convention, adopted by the Verkhovna Rada on July 6, 1999.

The widespread use of money surrogates in Ukraine causes many problems.[206] Veksels complicate the conduct of monetary policy by weakening the National Bank of Ukraine's (NBU's) direct control over liquidity in the economy. How can the NBU control the money supply when enterprises themselves are creating "money"? The system of barter and veksel settlements allows enterprise managers to skim profits and allows enterprises to avoid paying taxes.[207] Employees receiving wages in goods must expend considerable resources to convert the goods into cash or products needed for consumption. The use of veksels and barter significantly complicates

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however, that the GOU intends to allow regional administrators to start working with veksels once again.

[206] Veksels have become one of the most actively traded types of securities on the organized market. For example, between October 11 and 15, 1999, veksels accounted for 41.6 percent of the value of all securities traded on PFTS and the Ukrainian Stock Exchange, although the percentage has declined since then. The percentage of trading volume represented by veksels is high in general because shares very often are traded "over the counter" and the Government bond market is inactive.

[207] Enterprises avoid taxes directly by paying taxes with veksels that they never intend to, or are not able to, honor. They also avoid taxes indirectly using more sophisticated debt trading schemes. For example, a profitable enterprise can transfer to a loss-making enterprise a liability (in the form of a veksel that the loss-making enterprise agrees to pay) along with goods of an equivalent or greater value. The profitable enterprise reduces its future income and thus future taxes, while clearing its balance sheet of a liability. The loss-making enterprise sells the finished goods, but still does not have a profit and therefore does not pay taxes on the additional revenue. Although the loss-making enterprise may settle the veksel for less than its full amount, in which case the amount forgiven will be taxable income, there may still be no tax due if the company is losing enough money on its operations. The loss-making enterprise may then share some of the tax savings with the profitable enterprise "under the table." (STA report No. 325/96 dated January 10, 1999, and analysis by M. Wiener, June 4, 1999).

determination of the real financial position of enterprises and reduces the accuracy of financial disclosure. Finally, both barter and veksels are inefficient and expensive forms of settlement and thus raise the costs of all goods and services in the economy. Veksels can reduce the costs associated with barter, but veksels are still considerably more costly than cash settlements would be.

Ukraine should take gradual steps to restrict the use of money surrogates.[208] Ironically, much of the use of money surrogates is Government sponsored, often as a way of effectively expanding the money supply. This is perhaps most egregious in the agricultural sector, where the Government barters inputs for crops. As a result, farmers "buy" inputs high and "sell" outputs low, resulting in a lack of profits and new investment.

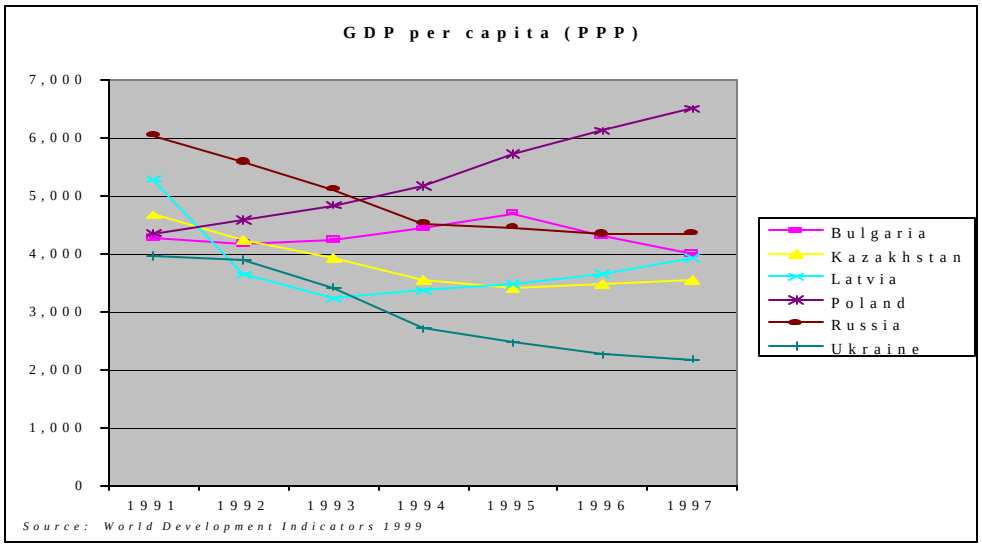
Ukraine's Virtual Economy

An economy is emerging in Ukraine that is based on illusion, or pretence, about almost every important aspect of the economy: prices, sales, wages, taxes, and budgets. Barter, veksels and debt arrears are used to create and perpetuate the illusion that the economy is larger than it is. Prices are charged which no one pays in cash; nothing is paid on time; huge mutual debts are created that cannot be paid off; wages are declared and not paid; and taxes are paid with money substitutes. Veksels now account for close to 50 percent of local governments' revenue. Arbitrary pricing obscures the fact that the inefficient manufacturing sector is, in many cases, destroying rather than creating value – although the "virtual" pricing allows certain actors supporting the manufacturing activity of these inefficient enterprises to receive quite real "super-profits." Finally, no reliable information is available about economic activity and thus it is impossible for policymakers to make informed decisions.

Official figures show that Ukraine has suffered from 11 years of declining GDP, a chilling statistic especially when one considers that this is as long as the Great Depression of the 1930s, which is considered one of the world's great tragedies. Commentators usually point out that the GDP figures in Ukraine are understated because of the growth of the shadow economy, with official statistics not capturing such activity. But the "virtual economy" phenomenon also means that these figures are *overstated* because official figures are based on arbitrary pricing and non-cash payments. Thus, it is unclear whether economic output is larger or smaller than official figures indicate.*

* Recent State Statistics Committee data show that GDP is finally growing, but it is too soon to know if these data are accurate.

[208] Encouragingly, President Kuchma issued a Decree in December 1999 giving the COM one month to liquidate UkrSpetsFin, a structure that had recently been recently created at the State level specifically to trade in enterprise debt.



To some extent, the use of money surrogates can be reduced naturally if the money supply is increased by decreasing the budget deficit and the amount of borrowing by the GOU. But once adequate money is available, further steps will undoubtedly be needed, such as restrictions on State bodies issuing or accepting money surrogates, and discounts on tax and other obligations to the Government paid in cash. Because money surrogates are widely used in tax evasion and profit skimming schemes, reducing their use will also require increased sanctions and stricter enforcement by the State Tax Administration (STA) and criminal prosecutors aimed at eliminating those schemes. Moreover, the array of complex schemes involving money surrogates demonstrates that Ukrainians will go to great lengths to find technically legal arrangements to avoid taxes. Consequently, it is imperative that the STA be empowered to attack arrangements that seek to achieve technical compliance with the letter of the law but are in fact designed specifically to avoid taxes.[209]

> *We ask American businessmen or Ukrainian businessmen: "Why do they not invest more here?" We get the same answers: high and unpredictable taxes, complicated and arbitrary regulations, [and] corruption.*
>
> U.S. Ambassador Steven Pifer in a December 2, 1999 address to the students of Taras Shevchenko University

Successfully reducing the use of money surrogates will require reducing the shadow economy (illegal, informal or unregistered business activity), as money surrogates are what the shadow economy uses to avoid detection. And reducing the shadow economy is inevitably tied to efforts to reduce corruption, which in turn is one of the keys to developing continued and sustainable economic growth in the economy. The GOU is currently attempting to reduce the shadow economy by enforcing tax collections and seeking out and publicly punishing major tax evaders.[210] Other approaches, however, are also needed:

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[209] The doctrine of "feigned and fictitious transactions" might constitute a proper legal framework to attack such arrangements (Article 58 of the Civil Code of Ukraine).

[210] The GOU's tax collection efforts involve: introducing new taxes and new methods for calculating and paying taxes and auditing taxpayers; expanding the mandate of the STA (such as allowing the use of indirect methods to reveal tax evasion – ownership of cars, houses, bank accounts, and

- Increase the *transparency* of Government action through public hearings, clear and simple laws, publication of Government actions, and a free and vibrant press;
- Increase *competition* in Government actions through open and competitive bidding for public works projects;
- Deregulate the economy – simplify rules and regulations, and lower the number of inspections and the number of required licenses – to reduce the frequency and intrusiveness of contacts between the private sector and bureaucrats with discretionary power;
- Reduce the number of benefits that are subject to the discretion of public officials through either eliminating (or privatizing) public activities or subjecting them to competition and market forces;
- Improve contract enforcement and legal protections for property so that parties have an incentive to move into the formal sector in order to enjoy these protections;
- More closely tie pension benefits to contributions, and improve record-keeping, so that employees have an incentive to receive their wages legally;[211]
- Reduce the overall tax burden;
- Impose harsh, swift and certain penalties for official corruption, including legislation which facilitates the confiscation of the proceeds of crime;
- Increase the probability of detection and punishment of official corruption through special investigative units comprised of auditors, lawyers, investigators and IT experts;
- Introduce Government agency budget and financial systems with built-in controls, and agency procedures that require internal review and oversight of regulatory approvals, licensing decisions, and decisions to impose sanctions;
- Initiate a public education campaign to develop a culture of zero tolerance of corruption so that people are taught the real cost of corruption to society (e.g., it has been estimated that the wealth of the average citizen can be doubled by eradicating corruption);
- Launch Government-wide ethics guidelines, as well as integrity pledges and personal financial disclosure by top officials; and, importantly,
- Increase the wages of Government employees while reducing their overall number.

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expenditures on foreign travel); requiring collateral against tax liabilities; accelerating bankruptcy procedures against companies in default on their tax payments; and putting direct pressure on enterprise directors to pay taxes due. For example, COM Resolution No. 1648, dated September 7, 1999, authorizes a number of coercive measures for collecting tax debts from enterprises. Pursuant to the resolution, heads of ministries and other central and local executive bodies are instructed to ensure that targets are met for reducing enterprise tax arrears. Among other methods, finished stock in warehouses of delinquent enterprises will be inventoried and possibly confiscated. The STA is responsible for overseeing trade operations and cash flow in connection with these measures.

[211] A ten month pilot program was recently completed in L'viv oblast in which personal deposit accounts were introduced to the current (Pillar I) pension system. With personal accounts, employees could be reasonably sure that they would receive pension benefits if, and only if, they received their wages legally. The program appears to have had some modest success at bringing workers into the official economy.

Once the shadow economy begins to shrink, the process should accelerate as firms begin to feel that they no longer need to avoid taxes just to compete with other tax-avoiding firms.

Share of the shadow economy	% of GDP
Georgia	64
Ukraine	47
Italy and Latin America	30
African countries	30
Uzbekistan	13
USA	8-12
Canada and France	5-8
Norway and Sweden	6-7
Source: World Bank	

5. Reduce Corruption and Intermediaries' "Super-Profits": Bringing the profits of intermediaries in the energy and raw materials markets into line with normal international levels is critical to any effort to bring down the costs of production inputs. As mentioned, market infrastructure can increase competitive trading of production inputs, which can effectively attack the problem. Changes in law are also necessary to add protections against such corruption. These protections generally take the form of provisions against "affiliated transactions." The draft law "On Joint Stock Companies," for example, provides that if an enterprise buys or sells materials from an entity with which one of its managers is affiliated, or if a manager receives payments in connection with the sale or purchase of materials by the enterprise, these transactions must be specifically approved by the supervisory board or, if large enough, the general shareholders meeting.[212] Such protections can also be added to companies' charters.

The new law "On the Restoration of Solvency of the Debtor or Declaring it Bankrupt" also provides powerful tools to fight against transactions with intermediaries that are unprofitable or that involve corruption. The new law grants arbitration courts and bankruptcy trustees powers to reverse or refuse to honor such agreements if an agreement: i) is unprofitable for the debtor company; ii) will interfere with the debtor regaining solvency; iii) was concluded during the six months leading up to initiation of the bankruptcy proceeding; or iv) was concluded with an "interested person" – i.e., a legal or natural person connected closely with the debtor company or its officers (Art. 17.10-11). Thus, after initiation of a bankruptcy proceeding when the bankruptcy trustee assumes control of the debtor company, he is not bound by any unprofitable agreements that the managers may have entered into with trade intermediaries or others, and, in fact, can petition the court to reverse certain previous agreements and return the money or goods to the debtor company.

Ukraine's National Accounting Standards (NAS) will require disclosure of affiliated party transactions.[213] Thus, expanded use of audits based on NAS will help to combat the problem. This is crucial. The Government cannot fight these problems alone. Well trained professional auditors are an important way that the private sector can be enlisted in the fight.

Finally, many of the schemes involving trade intermediaries violate the existing criminal code. Thus, what is needed is increased enforcement. Unfortunately, to the

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[212] Requiring approval of affiliated transactions is better than outright prohibition for two reasons. First, such a transaction might be beneficial to the company— e.g., if the manager has an ownership interest in the lowest cost supplier of a certain input. Second, outright prohibitions tend to simply force the activity further into the shadows rather than eliminate it. Administrative penalties for persons that evade the approval procedures, however, must be severe. The deterrence effects of high penalties are necessary to balance the fact that violators are seldom caught.

[213] International Accounting Standards (IAS) require disclosure of affiliated party transactions. The National Accounting Standards approved to date in Ukraine do not address affiliated party transactions, but it is expected that future standards will.

extent officials share in the profits from such schemes they will block any such enforcement actions.

6. Advance Sector-Specific Reforms: The sector-specific reforms necessary to reduce costs in each production input sector are beyond the scope of this Paper. It is worth mentioning some of them, however, as they are crucial to any effort to reform production inputs markets. Many of the necessary prescripts are well known by now, and some of them are underway. For example, reforms proposed by the World Bank include:

Agriculture

- Limit State intervention in the agricultural sector, such as manipulating the import and export market through targeted duties and tariffs and bartering inputs for grain (Box 11.2). By some estimates, through marketing arrangements and commodity loans, the State still retains effective control over 90 percent of trade in agricultural commodities;
- Further develop the institutional framework required for market-based agriculture and encourage domestic and foreign investors to supply the capital needed to improve the supply of primary agricultural inputs, storage handling and processing. Until the Government stops controlling the agricultural sector and allows prices to be set by market mechanisms in a transparent fashion, banks will be unwilling to provide credit and investors unwilling to invest in the sector;

Box 11.2

The Wrong Approach

The State seems unable to refrain from controlling production and distribution in the economy. This is perhaps most dramatic in the agriculture sector. On September 28, 1999, President Kuchma signed a law imposing a 23 percent duty on sunflower and other oil seed exports. The explanation given was that the state wants to discourage exports when output is only enough to cover domestic needs – i.e., the needs of Ukraine's oilseed refineries and vegetable oil producers. This move, however, is likely to have severely negative consequences in the medium term. Seed farmers will have no incentive to grow more than the domestic market demands and the trickle of investment into the sector will dry up. Ironically, it is the refineries themselves who will be hurt in the coming years as production decreases. Many farmers will exit the market, having decided that it is not profitable to grow oil seeds, and those that remain will have much less money for plantings.

The International Monetary Fund, apparently without success, has advised the GOU that the problem of supplying raw materials to seed oil refineries should be solved by purchasing seeds on the domestic market at world prices; that exports should be encouraged because they bring profits and investment; and that an export duty is the worst way to generate funds for the budget because it will curb farming sector exports at a time when the country's hard currency reserves remain low.

- Increase farm restructuring, improve corporate governance and create hard budget constraints in the agricultural sector;
- Speed up land privatization;[214]

[214] Despite a 1993 law on restructuring collective agricultural enterprises, most agricultural land remains within the former State farms, the structure of which has changed little since the period of collectivization in the 1930s. The 1993 law and other initial reforms sought to break Ukraine's more than 12,000 Soviet-era farms into more efficient units, but the transition has been slower than expected. Today only around 20 percent of all agricultural land in Ukraine is privately farmed, and

Coal

- Restructure the coal industry — focus scarce funds on the few viable mines rather than trying to keep all mines operating, while at the same time diversifying coal mining regions into new economic activities and finding ways to create new jobs in these regions (such as microcredit programs, small business support centers, and making available underused public buildings and warehouses for new businesses);
- End cross-subsidization of non-performing mines;

Power

- Implement market-based retail tariffs for electricity;
- Achieve effective collection of retail electricity tariffs, including arrears;
- Ensure rule-based operation of the wholesale electricity market, with a comprehensive and transparent Market Funds Procedure;

Gas

- Place natural gas sales on a solid commercial foundation;
- Organize regular gas auctions where gas traders and large consumers can pay cash for gas — based on freely negotiated prices — from gas producers and Ukrgazprom's successor;
- Establish a State-owned joint stock company to operate the gas transmission network and appoint a consortium of domestic and foreign companies to manage the shares of this company for at least 15 years. Limit Ukrainian State ownership in the consortium to 25 percent plus one share;
- Improve the metering and tracking of natural gas, heating and hot water flows, including the introduction of contractual arrangements for the settlement of differences on a daily and monthly basis;

Heat

- End the cross-subsidization of household consumers by industrial consumers for heating services;

General

- Phase out the system of privileges to certain categories of persons in pricing utilities and replace it with a comprehensive social safety net to protect those least able to pay; and
- Encourage energy conservation.

Reduce the Cost of Imported Production Inputs. The *direct* costs of imported production inputs are not particularly high. Tariffs are only about 15 percent. *Indirect* costs associated with imported production inputs, however, often increase the cost of these materials. For example, a significant cost-raising barrier to imports is the Government's quality and standards inspection system, overseen by the State Standards Committee. Ukraine generally does not accept goods simply because they meet well-recognized foreign standards, and instead insists on subjecting even products widely sold in Europe to Ukraine's costly and time consuming laboratory inspections. The inspection fees – reportedly up to $250,000 for one widely reported

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not more than 3.1 percent is non-subsistence farming. President Kuchma issued a decree on December 3, 1999, just three days into his second term, ordering the Government to break up collective farms into private farms and cooperatives "on the basis of private land ownership." The decree will face resistance, however, from collective farm directors who profit from the status quo, and from factions in the Verkhovna Rada who are claiming that the decree violates the Constitution. The Decree, which is similar to a decree Kuchma issued at the beginning of his first term, also leaves unanswered some important questions, such as what happens to collective farms' (mounting) debts when farmers withdraw from the collective.

case involving household cleaning products – seem designed to cover more than the cost of the inspection. Further, the customs service is cumbersome and believed to be plagued by corruption, adding costs and delays to the import process.

One approach to reducing import costs is to put quality inspection and customs on a commercial basis, engaging one of the international private companies that offer pre-shipment inspection services (Indonesia was successful with this approach). Once goods have passed quality certification by the inspection company at the point of origin, they are automatically cleared in the country of destination. The pre-shipment inspection company also handles all customs revenues, passing them directly to the national budget. In countries that have tried this approach, the increased customs revenues that result from reduced corruption have more than paid for these services. As it may be politically unacceptable to contract out the entire customs service, Ukraine might consider implementing such a system only for certain problematic points of entry, such as Odesa.

Further, Ukraine could dramatically improve the situation by simply agreeing to recognize certain foreign standards and not subjecting products meeting those standards to its own inspections. The GOU's "Ukraine 2010 Program" calls for the country to work toward joining the World Trade Organization by 2010. Doing so will require Ukraine to sign bilateral agreements with other members which will involve co-recognition of product certification standards in most areas. Importantly, nothing but political will prohibits Ukraine from taking this action unilaterally today.

Recession and Growth in Transition Economies, 1990-97							
Countries	Years of GDP Decline	Did GDP fall after some growth?	Average annual rate of GDP Growth			1997 GDP Index (1989 = 100)	Rank
			90-93	94-97	90-97		
Poland	2	no	-3.1	6.3	1.6	**111.8**	**1**
Slovenia	3	no	-3.9	4.0	0.0	**99.3**	**2**
Czech Republic	3	**yes***	-4.3	3.6	-0.4	**95.8**	**3**
Slovakia	4	no	-6.8	6.3	-0.3	**95.6**	**4**
Hungary	4	no	-4.8	2.5	-1.1	**90.4**	**5**
Uzbekistan	5	no	-3.1	-0.3	-1.7	**86.7**	**6**
Romania	4	**yes**	-6.4	2.1	-2.2	**82.4**	**7**
Albania	4	**yes**	-8.8	4.9	-2.0	**79.1**	**8**
Estonia	5	no	-9.7	4.1	-2.8	**77.9**	**9**
Croatia	4	no	-9.9	3.0	-3.4	**73.3**	**10**
Belarus	6	no	-5.4	-2.6	-4.0	**70.8**	**11**
Bulgaria	6	**yes**	-7.4	-3.6	-5.5	**62.8**	**12**
Kyrgystan	5	no	-9.3	-2.4	-5.8	**58.7**	**13**
Kazakhstan	6	no	-6.7	-6.0	-6.3	**58.1**	**14**
Latvia	4	**yes**	-13.8	2.2	-5.8	**56.8**	**15**
Macedonia	6	no	-12.9	-0.8	-6.9	**55.3**	**16**
Russia	7	**yes***	-10.1	-5.3	-7.7	**52.2**	**17**
Turkmenistan	7	no	-4.5	-12.5	-8.5	**48.3**	**18**
Lithuania	5	no	-18.3	0.5	-8.9	**42.8**	**19**
Armenia	4	no	-21.4	5.4	-8.0	**41.1**	**20**
Azerbaijan	6	no	-14.5	-5.7	-10.1	**40.5**	**21**
Tajikistan	7	no	-12.2	-8.4	-10.3	**40.0**	**22**
Ukraine	8	**no recovery**	-10.1	-12.1	-11.1	**38.3**	**23**
Moldova	7	**yes***	-12.6	-10.2	-11.4	**35.1**	**24**
Georgia	5	no	-24.1	2.9	-10.6	**34.3**	**25**
* GDP contracted again in 1998							
Source: Kolodko (1999)							

Action Points:

- **Focus on sustainable strategies to make Ukraine more attractive for investors, such as reforms that will bring the costs of production down to market levels, rather than "quick fix" policies such as tax privileges, subsidies to investors, loan guarantees, and so on;**

- **Encourage the development of efficient commodity exchanges for metals, energy resources, and agricultural products to provide for competitive trading of these resources;**

- **Attract trading onto commodity exchanges through improvements in infrastructure, rather than forcing it through heavy-handed requirements such as that all grain contracts be registered at exchanges;**

- **Fully privatize enterprises in the energy and raw materials sectors to bring foreign investment and increased competitiveness. Fully privatize grain elevators and storage facilities; pursue genuine privatization of farms; continue to privatize viable coal mines; complete privatization, as planned, of all four power generators and 27 oblenergos; and privatize the natural gas sector (without creating exploitative private monopolies);**

- **To reduce the prevalence in the economy of late payment, non-payment and payment using cash substitutes, implement incentives to improve collection rates (particularly cash payments), including disconnections and service cut-offs, formal rescheduling of arrears, a credible threat of bankruptcy, a threat of collection actions in court, and public awareness campaigns;**

- **Take gradual steps to restrict the use of money surrogates (barter, mutual settlement of outstanding debts, and veksels). Consider restrictions on State bodies issuing or accepting money surrogates, and discounts on tax and other obligations to the Government paid in cash;**

- **Increase sanctions and enforcement to eliminate tax evasion and profit skimming schemes involving money surrogates and trade intermediaries;**

- **Empower the STA to attack arrangements that seek to achieve technical compliance with the letter of the law but are in fact designed specifically to avoid taxes;**

- **Take aggressive steps to reduce corruption and the shadow economy. In this regard, consider implementing some or all of the suggestions outlined in the text;**

- **Work to improve legal protections to ensure that "affiliated transactions" – e.g., when an enterprise buys or sells materials from an entity with which one of its managers is affiliated, or if a manager receives payments in connection with the sale or purchase of materials by the enterprise – are fully disclosed and occur at arms-length, market prices;**

- **Implement sector-specific reforms to reduce costs in each production input sector. Consider implementing some or all of the suggestions outlined in the text;**

- **Consider engaging a pre-shipment inspection company to be responsible for quality inspection and customs for certain problematic points of entry, such as Odesa; and**

- **Agree to recognize certain foreign product certification standards and stop subjecting products meeting those standards to inspections in Ukraine.**

Conclusion

Ukraine today is a transitional economy with financial markets at an early stage of development. To accelerate the development of the financial markets, increased efforts must be made in two directions: developing the correct *regulatory framework* and encouraging *private sector initiatives*. First, the Government must establish the correct legal, regulatory, and institutional framework for healthy financial markets and a culture of *confident expectations* about transactional activity. Second, the private sector must be allowed and encouraged to act within the framework established by the Government.

The *regulatory framework* requires greater coordination among State bodies to foster the proper linkages between financial market activities. This Paper has suggested initiatives involving the Cabinet of Ministers (COM), Presidential Administration, Verkhovna Rada, and more than fifteen specific Government agencies. Some of the suggested reforms are underway now and simply need to be intensified or finalized; others have not yet begun. A linked and coordinated approach is essential for Ukraine to improve its financial markets regulatory framework.

> *Today we need a reform-minded Government, not just reformists in the Government. . . . The policy of small steps and compromises we have been pursuing is leading the economy to stagnation. The time for compromises is over – now is the time for radical changes.*
>
> Deputy Prime Minister Serhiy Tyhypko, in a public statement November 29, 1999

The *private sector initiatives* will flow naturally once the Government establishes the correct framework and then (mostly) gets out of the way.
Ukraine needs to articulate a clear policy regarding the proper role of the State versus the private sector; the State as lawmaker and regulator should limit its actions to broad policy, setting a level stage on which economic actors can perform freely. Once a culture of *confident expectations* is created, private sector actors will step forward to develop financial market industry standards, operational systems, increased transactional activity, investment, enterprise restructuring and job creation. Private sector actors, once enabled and unhampered, will do most of the work.

Ukraine can successfully develop its financial markets. The initiatives outlined in this Paper, as refined by Ukrainian officials, can establish an enabling regulatory climate, efficient market architecture, and empowered private sector actors. These improvements will facilitate an environment of fair and confident expectations for economic behavior that, in turn, will facilitate the emergence of developed financial markets in Ukraine over the next five years.

A Success Story:
What the Market can Achieve if the Government Lets It

Ukraine's food sector has attracted more foreign investment than any other sector due to limited Government interference and large numbers of privatized small and medium-size enterprises. Local companies have found that consumers increasingly prefer quality domestically-produced foods to expensive foreign imports, and have quickly taken advantage of this trend. Breweries have been some of the more successful enterprises, attracting more than $100 million in foreign investment between 1997 and 1998. Foreign investments in confectioners have enabled Ukrainian brands such as Svitoch and Korona to displace foreign imports. Small dairy, juice, and condiment makers are also benefiting from foreign investment by using foreign-made equipment to create quality, attractively packaged products that are gradually replacing imported foods. The indirect effects of foreign investment are also readily observable. Competition among breweries has necessitated large advertising campaigns, bringing money into this sector as well. Retailers have increased profits by selling less-expensive domestic goods for the same price as foreign imports. *The Government's hands-off approach is in large part the reason the food industry is profitable and has attracted Hr 3.11 billion ($622 million) or over 22 percent of all foreign investment.*

A Framework for Financial Sector Development

Establish Policies that Increase Confidence in the Market

- **Political Stability**
- **Smaller Government**
- **Trade Liberalization**
- **Free Market Competition and Establishment of a Favorable Investment Climate**
- **Sound Monetary Policies**
- **Responsible Fiscal Policies with Hard Budget Constraints and a Reduced Budget Deficit**
- **Improved Debt Management System**
- **Fewer Government Subsidies of Enterprises (loan guarantees, directed credits, tax privileges, etc.)**
- **Reduced Corruption and Unfair Practices**
- **Decreased Shadow Economy**
- **Deregulation**
- **Government Transitioning from a Soviet (control) to a Market**
- **Transparency and Disclosure**
- **Certainty of Property Rights and**
- **European Union Harmonization**

Build the Legal and Regulatory Framework

Laws
* contract law (civil code)
* company law
* securities law
* competition law
* banking law
* bankruptcy law
* pension law
* collateral law
* tax law
* international trade and investment laws
* privatization law

Rules and Regulations
* government agency regulations
* SRO[1] rules

Private Contracts

Compliance Mechanisms
* incentives and discipline imposed by the market
  - search for efficiency gains, transaction cost and risk reductions
  - competition
  - transparency
  - traditions, shared values and expectations
* government and SRO authorization and oversight
  - licensing
  - training
  - periodic reporting
  - examination
  - investigation
* enforcement and dispute resolution
  - informal arrangements (e.g., complaint boards, advisory councils)
  - administrative actions by State regulatory agencies
  - sanctions imposed by SROs
  - civil courts
  - criminal courts
  - private arbitration and other

Develop Institutions and Market Infrastructure

Enterprises
* improve corporate governance
* restructure existing enterprises
* encourage the creation and growth of small and medium sized enterprises

Banking Institutions and Infrastructure
* commercial banks
* credit unions
* payment systems
* currency exchanges
* clearing and settlement facilities

Securities Market Institutions and Infrastructure
* securities traders (underwriting and secondary market transactions)
* investment advisers
* trade organizers (stock exchanges, electronic stock markets, commodities exchanges)
* depository, clearance and settlement facility
* securities ownership registries (registrars, central depository)
* custodians

Public Registries
* registry of title to real property
* registry of mortgages on real property
* moveable property pledge registry
* registry of bankruptcy cases
* central registry of legal entities

Regulatory Bodies
* banking regulator
* securities market regulator
* tax authority
* pension system regulator
* anti-monopoly authority
* other related government regulatory bodies

Develop Financial Instruments and Markets

Commercial Loans
* short term
* long term

Fixed Income (debt) Securities
* state bonds
* municipal bonds
* corporate bonds

Equity Securities (shares)

Products offered by Collective Investment Institutions
* investment companies and funds
* non-state pension funds
* insurance companies

Derivatives (futures and options)[2]
* currency derivatives
* commodity derivatives
* securities derivatives

Negotiable Instruments
* promissory notes
* bills of exchange

Securitized Instruments
* real estate investment trusts[3]
* mortgage backed certificates[4]
* venture capital closed-end investment funds[5]

Other
* leasing
* housing loans
* agricultural credit
* supplier's credit
* venture capital

Develop Other Financial Sector Activities

- **Accounting and Auditing**
- **Independent Appraisers**
- **Debt Rating Agencies**
- **Financial Analysts**
- **Financial Press**
- **Insurance Industry**
- **Actuaries**
- **Legal Profession**
- **Bankruptcy Trustees**
- **Deposit Insurance**

Upgrade Skills

- **Seminars for Policymakers and Lawmakers**
- **Training Institutes for Market Professionals**
- **Training for Enterprise**
- **Small Business Support Centers**
- **Chambers of Commerce**
- **Judicial Training**
- **Institutional Development**
- **Investment in Primary and Secondary Education**
- **Public Awareness and**

[1] Industry self regulatory organizations

[2] Futures and options are hedging instruments that allow one to reduce or eliminate the risk of unknown future price movements in the underlying good. These instruments can also be used to speculate when investors feel that they know which way prices are headed and want to bet on their beliefs.

[3] Real estate investment trusts are companies that take equity positions in real estate projects, or loan money to real estate developers, and in turn issue liquid securities to investors.

[4] Mortgage backed certificates are liquid securities backed by a pool of (illiquid) home mortgages.

[5] Venture capital closed-end investment funds issue liquid securities and in turn invest in start-up companies (i.e., highly illiquid, individually negotiated deals).

EXECUTIVE SUMMARY

Introduction

◆ This Paper analyzes the current condition of financial markets in Ukraine and recommends specific policy initiatives designed to revitalize these financial markets and promote economic growth. This paper emphasizes the critical links between different economic activities and presents action points for consideration by Ukrainian officials. Taken as a whole, we believe that the Paper presents a serious reform agenda.

1. Rationale and Framework for Reform

◆ Financial markets development is crucial to the process of reviving Ukraine's moribund economy. Well functioning financial markets direct capital to those companies best able to put it to productive use and create jobs. Financial markets also facilitate accumulation of capital from foreign and domestic sources. Finally, financial markets play a role in restructuring of enterprises as new strategic investors assist enterprises to modernize their operations. In a market economy, capital allocation decisions are left to the markets themselves. It is thus crucial that these markets function efficiently.

◆ Perhaps the most important first step is to break the bureaucracy's hold on the economy. The economy must be deregulated, and the administrative process changed across all ministries and agencies. Officials should focus on promoting a good business environment. What exists currently in Ukraine is a kind of "bureaucratic capitalism" halfway between a command and a free economy. Despite progress in privatization, ministries and agencies still use what means they can to control the economy. The "Gosplan mentality," where the State determines what actions will be implemented and then encourages their implementation, must be abandoned and replaced with a "private sector enabling mentality" where the State puts in place fair and consistent rules and the private sector itself determines what actions will be implemented. This requires State officials to stop thinking of themselves as the architects of economic activity – the State should act as lawmaker and regulator, setting a level stage on which economic actors can perform freely.

◆ Beyond that, financial markets development should be undertaken with two overriding principles in mind: *transparency* and *confident expectations*. The aim of almost all decisions related to financial markets development should be to increase one or both of these transactional imperatives.

◆ *Transparency*. In contrast to a command economy, a market economy involves decentralized decisionmaking. Markets cannot function properly unless these decentralized actors have full and accurate information. Thus, the need for *transparency*. This includes transparent privatization of State property so that investors have trust in the process, reducing the premium they demand for investing; transparent disclosure of information by companies to investors and creditors so that financing is directed to viable enterprises and not wasted on failing ones; transparent disclosure of business relationships so that legal protections against affiliated party transactions are effective; transparent dissemination of information about prices and volumes of trades in securities so that prices on stock exchanges accurately reflect supply and demand, and so on.

◆ *Confident Expectations*. In a market economy, no one is forcing investors to invest or creditors to lend. They will do so only if they confidently expect that contracts will be honored and enforced; that loans will be repaid; that the Hrivna will hold its value; that the interests of creditors and shareholders will be protected; that financial information will be reliable; that tax policy will be fair and consistent; that corruption will not result in the assets being stripped from a company in which they have invested; and that the State will not unfairly change the rules of the game. An environment of confident expectations must be promoted.

◆ Different aspects of financial markets development are *inter-linked*. For example, meaningful privatization is required before securities markets can develop, and developed securities markets are required before private pension funds can safely invest in assets inside the country. Similarly, the court system must operate independently and effectively before contracts can be enforced, and contract enforcement is a prerequisite to secured lending and bankruptcy rules that are needed to encourage banks to loan money to enterprises. International accounting standards are important for good corporate governance, and good corporate governance is necessary to encourage investors to participate in international privatization tenders that bring money to the State and know-how and financial resources to enterprises. Finally, efforts to support enterprises through tax privileges, cheap energy and other benefits put stresses on other parts of the system, reducing budgetary funds available for investment in needed infrastructure, and increasing the tax burden on a narrow group of efficient, profitable enterprises that operate in the official (non-shadow) economy.

◆ Perhaps the most important example of the *inter-linkages* between the various aspects of the financial markets is the effect of the shadow economy on financial markets development. Until the shadow economy is reduced, financial markets development will be severely restricted. As the very name implies, the shadow economy involves greatly reduced *transparency*. How can capital allocation decisions be made effectively when companies' financial disclosure is compromised by unreported transactions, double sets of books, and difficult-to-value barter transactions? The shadow economy also severely reduces the *confidence* of economic actors in the system. When transactions are hidden, the courts cannot be used to enforce contracts and the Government is ineffective as a regulator.

◆ Attacking corruption at all levels is essential. From State officials to judges to enterprise managers and controlling shareholders, corruption undermines confidence in the financial markets. Capital will not flow into the economy if investors believe that a competitor can bribe a judge or State official to gain an unfair advantage, or believe that the profits of a company can be skimmed away by dishonest managers or controlling shareholders.

2. Reinvigoration of Large-Scale Privatization

◆ Russia and Ukraine took different privatization paths. After the break up of Soviet Union, Russia proceeded quickly with large-scale privatization and the results can only be called disastrous. Rather than investment, restructuring and growth, Russia has seen massive looting of enterprises by the new "kleptocrats," coupled with dramatic capital flight. Ukraine, on the other hand, has proceeded more slowly with large-scale privatization, but has done no better. It is also crippled by massive corruption, capital flight, and eleven years of declining gross domestic product (GDP). Thus, in crafting a large-scale privatization strategy going forward it is important to ask what, if any, lessons can be drawn from the experiences of these two countries as well as from other countries around the world that have privatized formerly State-owned enterprises.

◆ It is only where privatization is associated with good corporate governance and restructuring that there is a positive impact on growth. To achieve good corporate governance in a country such as Ukraine with a weak legal system and poor shareholder protections, the initial share allocation in large-scale privatization should be highly concentrated, with a core strategic investor receiving at least a majority share. Incremental privatization is not the optimal approach because it then requires a great deal of time to assemble a controlling block of shares, and the value of enterprises deteriorates in the meantime.

◆ Privatization will be most effective if the core investor is not current management, but rather an outside investor with experience in the sector, a good management record, a strong reputation to maintain, and its own good corporate governance practices. Most often this will be a foreign investor. Care must be taken in screening bidders, however, because an honest bidder may offer less money for an enterprise than a dishonest one. This is because the honest bidder has to do the hard work of restructuring the enterprise to make it profitable, while the dishonest bidder has a competitive advantage in that he can evade taxes, obtain favors from the Government, "cheat" when fulfilling investment obligations, engage in price-fixing, enforce contracts through force rather than the court system, not pay workers, and engage in profit skimming and asset stripping.

◆ Consideration should be given to breaking large enterprises into smaller units before privatization, perhaps through the procedures of the new bankruptcy law. At a minimum, balance sheets should be cleaned up and labor forces trimmed to make enterprises more attractive to investors.

◆ The draft 2000 privatization program contains some attractive features that are in keeping with evidence from other countries around the world regarding the methods of privatization that result in increased productivity. But it may be fatally flawed if strategic investors are not offered majority stakes in enterprises. Moreover, the plan 2000 includes a troublesome system of "rewards" and "punishments" for investors (the "reward" being the right to purchase the State's remaining shares after three years). This attempt at an innovative device may simply doom the privatization effort as far as foreign investors are concerned. Serious investors have little reason to trust the Ukrainian Government. The Government should rely on better screening and pre-qualification of bidders and not retain 25 and 50 percent share packages at all – at a minimum, such share packages are a constant reminder that the State still wants to control corporate outcomes.

◆ The overall approach to tendering Ukrainian companies to foreign investors needs to be radically changed. Privatization of State property should be conducted quickly, according to simple, clear procedures. The transparency of the process needs to be increased. And the traditional emphasis on retaining State control over so called "strategically important companies" must be reversed. The "strategically important companies" are exactly the ones that should be offered, because they are the ones that will attract investors and the ones into which it is most critical that foreign capital and know-how be injected. International tenders should be undertaken for the most attractive companies; the companies that do not meet the established selection criteria should be offered through less elaborate methods. Ukraine should signal the international investment community that is has adopted a fresh market-oriented approach by conducting a high-profile "showcase" international tender of a major State-owned enterprise (e.g., Ukrtelecom, Donbasenergo, Motor Sich, Mykolayiv Alumina, etc.).

3. Bank Reform

◆ The banking sector is not contributing significantly to the Ukrainian economy. The capitalization of the entire banking system in Ukraine is equal to the capitalization of one large bank in Central Europe. One key problem is that banks are not attracting deposits because of the pervasiveness of the shadow economy and capital flight. In addition, banks are new at performing the functions of a bank in a market economy, rather than simply allocating credit as directed by the Government, which was their function under central planning. Under a market economy, banks must learn to screen and monitor borrowers, selecting projects and making decisions about which firms have the best prospects for successful expansion and thus loan repayment. But banks do not have adequate risk monitoring systems in place and are presently unable to gauge the risks associated with lending to enterprises.

◆ The National Bank of Ukraine (NBU) has made progress in implementing effective prudential regulation to ensure the safety and soundness of the banking system, but more needs to be done. The NBU should shift its focus toward issues that relate more closely to bank supervision and depository protection, and away from purely procedural violations, and should impose fines more closely in proportion to the seriousness of violations. Further, the NBU should vigorously enforce its existing capital requirements based on proper asset valuations, and examine the adequacy of each bank's capital in relation to its risk exposure, which will undoubtedly require a significant number of banks to be closed or reorganized. Consideration should be given to restructuring some banks into credit unions.

◆ Several legislative initiatives will be important to revitalize the banking sector. The revised law "On Banks and Banking Activity" should be finalized and passed quickly. A number of specific recommendations in this Paper could be achieved through this one step. In addition, the draft law "On Securing Performance of Obligations with Movable Property" should also be finalized and passed. Commercial lending in the economy will increase if it can be made simple and inexpensive for a debtor to convey a security interest to a creditor. This draft law will provide a comprehensive scheme for secured lending that reflects the needs of modern commerce. Finally, steps must be taken to ensure that the new law on bankruptcy is implemented in practice. A major initiative is needed to train judges, lawyers, trustees, creditors and debtors to understand and use the new law. A workable bankruptcy law will encourage lending by ensuring banks and other creditors that their claims will be handled fairly in the event of insolvency of the borrower.

◆ Small and medium-size enterprises (SMB) are the main engine for job creation in economies around the world. But the growth of SMBs in Ukraine is hindered by high tax rates and numerous taxes, corruption, excessive regulatory burdens, frequently changing legislation, and restricted access to capital. The regulatory burdens on SMBs appear to have improved in the last few years, but Ukraine still needs to work to expand this sector: in the West, SMBs account for forty to sixty percent of GDP, while in Ukraine they account for only about 8 percent.

4. Securities Markets' Role in Financial Markets Development

◆ The securities markets in Ukraine are under-developed and over-regulated. An estimated 80 percent of trades in securities are settled outside of Ukraine. Transparency is low – PFTS accounts for approximately 95 percent of the reported secondary market trading of shares, but this involves only an estimated 20 percent of all transactions concluded. The rest of transactions are concluded outside

of the organized market. The market today is mostly a market for consolidation of control of "strategic" enterprises. Partially as a result of the 1998 crises in Asia and Russia, and for other reasons specific to Ukraine, the volume of trade and valuations of securities are low, with little interest from either strategic or portfolio investors. To make matters worse, market manipulation is reported to be widespread with respect to the trading that does occur on the organized market, and many transactions in securities are purportedly based on insider information.

◆ Even though many professional market participants left the market as a result of the 1998 crisis, the securities markets remain decentralized, with many more broker-dealers and registrars than are justified by market activity. In addition, infrastructure risk in the market remains high because there is not yet a reliable clearance and settlement depository. Government officials and industry participants need to work to improve the markets and ensure that they are: reliable, safe, liquid, efficient, transparent, fair, and orderly.

◆ Policymakers should encourage the process of consolidating and upgrading registrars into a few restructured entities connected to a depository. The overall number of registrars should be greatly reduced. Certificated securities, both bearer and registered, should gradually be immobilized and dematerialized in a depository or custodian.

◆ Efforts are presently underway to develop a participant-governed depository, clearance and settlement system in Ukraine, the "All Ukraine Clearing Depository (AUCD)," based on the "Inter-Regional Stock Union (MFS)." It will be difficult, however, under present market conditions to develop a fully functional clearance and settlement depository that guarantees share transactions and mitigates counter-party risks. Initially, therefore, the AUCD may function more as a "central share re-registration facility," acting as a nominal holder and allowing re-registration of all eligible securities in one central location. Yet even this will greatly reduce the settlement cycle by standardizing re-registration procedures and eliminating the need to travel to independent registrars around the country.

◆ Unfortunately, Ukraine currently has two competing potential depositories for shares, the AUCD and the National Depository of Ukraine (NDU). The NDU is legally confined to three narrow, non-commercial functions, pursuant to a memorandum of understanding signed by the Government of Ukraine (GOU), but nonetheless has made its intentions to move beyond these three functions obvious to all. The situation has unfortunately become extremely politicized, is seriously harming the market, and must be quickly changed. The presence of the NDU looming over the AUCD creates great uncertainty and destroys the confidence market participants would need before they commit time and money to the AUCD (or, for that matter, to the NDU). The solution is to merge the NDU and the AUCD, *but only on the basis of statutory documents that separate Government ownership from control*. The Government should regulate the depository to ensure that it is safe and reliable, but not operate it or control the supervisory board.

◆ The Securities and Stock Market State Commission (SSMSC), established by presidential decree in June 1995 and given a broad mandate in October 1996 by the law "On State Regulation of the Securities Market in Ukraine," has made considerable strides in the past few years to begin to fulfill its assigned functions. More can be done, however, so that the SSMSC fully protects investors. Policymakers need to consider ways to strengthen the SSMSC, first and foremost by providing it with adequate funding.

◆ Small companies are over-regulated by current law and by the SSMSC. The focus of both law and regulation should be on the market for the securities of

large, actively traded companies. The SSMSC also needs to review its regulatory requirements for all market participants. It currently has too many filing, registration, and other requirements, the costs of which outweigh the benefits. Unnecessary requirements should be eliminated. Going forward, the SSMSC should improve the transparency of its regulatory process through a strict procedure requiring publication of the text of proposed new regulations in the SSMSC's magazine "Ukrainian Securities," with a set period of time during which market participants can provide suggestions. The SSMSC also needs to improve its review of issuer annual and special reports, particularly to ensure compliance with the new National Accounting Standards. Finally, too many SSMSC enforcement cases are for technical violations that have no direct effect on the market. In this regard, the SSMSC is similar to the NBU, and, we suspect, similar to many other Government agencies in Ukraine.

◆ There are currently approximately 850 broker-dealers, approximately 375 registrars, and, incredibly, 8 trade organizers and 10 self-regulatory organizations (SROs) in Ukraine. Given the size of the Ukrainian market, these numbers should be perhaps a third what they are. The SSMSC sets licensing standards too low, and fails to protect investors by ensuring that only well-capitalized, qualified market intermediaries receive a license. Standards should be raised and licenses withdrawn from those not able to meet the higher standards. The SSMSC may soon grant licenses to a new category of market professionals, investment advisers, in which case we urge the SSMSC to avoid repeating the mistakes of the past and instead set high standards and restrict the issuance of licenses. Finally, the SSMSC needs to improve its monitoring of market intermediaries to ensure that they *continue* to meet licensing requirements.

5. The Government as Participant in the Financial Markets

◆ Government borrowing has a significant effect on financial markets. Positively, when the government borrows by issuing treasury bills and timely honors its repayment obligations, these securities can provide an important low risk investment vehicle. Negatively, if the government borrows a large share of the money available in an economy, there will be little or no money available to enterprises at reasonable interest rates to finance expansion and growth. The supply of capital is limited, particularly in a transition economy where money is too often fleeing the country, and the government as the dominate player can easily consume the available supply.

◆ In Ukraine over the last several years a mismatch between tight monetary policy and lax fiscal policy has resulted in a "crowding-out" or credit squeeze. Following prudent monetary policy, the NBU has sharply limited credit expansion, resulting in relative stability in terms of inflation and the exchange rate. But the GOU has not imposed the necessary tough budget constraints. This "soft budget culture" has resulted in large annual deficits. Consequently, the GOU's borrowing requirements have grown steadily, significantly exceeding total credit expansion in the banking system. The result has been unrealistically high interest rates and a shortage of credit for the productive sector.

◆ The dynamics of the situation changed somewhat in 1999 after the GOU restructured treasury bill payments by "voluntarily" extending maturity dates and the NBU stopped maintaining the Hrivna at the then-existing artificial exchange rate. These two actions destroyed real returns (in dollars) on treasury bills, and, together with the Russian crisis, effectively killed the treasury bill market. But this did not mean that money was suddenly available for commercial lending to enterprises. For various reasons, banks today have significantly less free Hrivna resources, above capital and reserve requirements, available to lend. Further, banks are unprepared

to shift from investing only in treasury bills to operating as true commercial banks making loans to enterprises. Consequently, commercial bank credit to enterprises in Ukraine is among the most expensive in the world.

◆ The Government also participates in the capital markets as the largest shareholder, with the State Property Fund (SPF) holding share packages in many large joint stock companies. Ironically, here too Government deficit spending results in less money available to enterprises (in the form of retained earnings) because the SPF is instructed to vote at general shareholder meetings for large dividend payments to raise money for the budget.

◆ It appears that fear of widespread unemployment (if failing enterprises are not supported) is one of the main reasons for Ukraine's excessive deficit spending. The Government continues to support failing enterprises, although the form has changed over the years since independence. Support currently takes the form of access to cheap land and energy and allowing such enterprises to "pay" their taxes in barter or with veksels and offering them various tax privileges (waivers or deferred payments of taxes and write-offs of budget loans and tax debts) and State guarantees for loans.

◆ The GOU should rapidly phase out all of the various direct and indirect supports for failing enterprises. The GOU needs to move from a Soviet approach to economic management, where the Government is directly responsible for enterprises, to a market approach, where enterprises are the responsibility of private owners. Fears of massive unemployment and social unrest if subsidies are removed are unfounded. The recent history of Poland illustrates that as inefficient jobs are lost, new jobs are created. Further, in realistic, relative terms, the current policy is causing more problems than would be caused by whatever unemployment would result from imposing hard budget constraints.

◆ Once the pride of Ukraine, infrastructure at the local and regional level is now in a state of decay. Bond offerings by local and regional governments (oblast, rayon, municipality, city and settlement) can help raise funds to repair and replace this infrastructure. Local government bonds can also provide a relatively safe investment vehicle. Policymakers should work to revive the market for local and regional government bonds while implementing institutional reforms to prevent a repeat of the Odesa fiasco.

6. Collective Investment Institutions and Pension Reform

◆ Collective investment institutions (investment funds, private pension funds, insurance companies, and other institutions that pool savings) can play a major role in enhancing economic growth, assisting financial markets development, and bolstering retirement living standards. In mature economies, with well developed legal and operational structures, collective investment institutions: i) create pools of capital for investment in debt and equity instruments; ii) attract investors into the market by allowing them to diversify risk and providing them the benefit of professional asset management; iii) increase market efficiency by compelling issuers to provide detailed information; and iv) play an important role in corporate governance by monitoring, and in some cases replacing, management at the portfolio company level, and by insisting on corporate restructuring.

◆ However, in transition economies such as Ukraine's, agglomerating capital pools and gaining the benefits they provide is jeopardized by several key factors: i) fear that corruption will lead to stolen assets; ii) fear that domestic government bonds and/or domestic shares will be mandated as the sole or dominant permissible asset

classes for investment, thus ensuring high risk investing; and iii) fear that inexperienced custodians, investment advisers, and management companies, coupled with inadequate licensing, monitoring, and enforcement, will threaten routine operations.

◆ Ukraine has almost 200 currently operating investment companies and funds, organized pursuant to a 1994 Presidential Decree. Most of these funds have sunset provisions that require their liquidation in 1999 or 2000. Considering that these funds are tied to the certificate privatization process, which has now ended, and that their investment portfolios are largely non-diversified and illiquid, these privatization funds need to be separately administered (i.e., liquidated or reorganized), subject to a different legal regime from new funds.

◆ Simultaneously, a workable legal framework for new investment funds, involving sound fiduciary principles and international best practices, needs to be developed. Finalizing and passing the draft law "On Collective Investment Institutions (Unit and Corporate Investment Funds)," which passed its first reading in September 1999, would be an important step towards creating an environment of confident expectations that over time may convince Ukrainians to entrust their savings to investment funds, putting this money to productive use.

◆ Ukraine, like many nations, is unable to meet existing pension obligations. This is common world-wide because pay-as-you-go (PAYG) systems are prevalent, and are often inadequate to meet the promised pension payments. Ukraine's pension system faces major challenges, including: i) low benefits; ii) widespread contribution evasion; iii) a large number of retirees; iv) inefficient administration; v) an unpredictable and unreliable system; vi) a financially unsound and unsustainable system; and vii) benefits paid almost without regard to work history.

◆ Pension reform is a complicated and major initiative. The discussion is generally framed in terms of the "three pillars" of pension reform: i) a continued compulsory government social insurance scheme that pays defined basic benefits financed on a PAYG basis (pillar one); ii) a forced savings program where a fixed percentage of an employee's wages is set aside, privately managed, and invested in an individual account, to gain in value and ultimately provide the retirement payments stream (pillar two); and iii) a voluntary savings plan that allows workers to set aside part of their wages – free of income tax until the funds are withdrawn at retirement – for investment in privately managed individual accounts to grow over time and supplement retirement income (pillar three). Many permutations from this basic framework have been implemented around the world.

◆ The management of funded pension schemes (whether pillar two or three) must be carefully monitored and subject to even tighter regulation than investment funds (investment fund regulation relies more on requiring disclosure of risks). Pension funds must be low risk, liquid and diversified. Initially, a preponderant portion of the assets in pillar two pension funds should be invested outside of Ukraine in a mix of foreign investment-grade assets. This requirement can be changed over time as the domestic markets develop.

◆ Laws are being developed to improve the pillar one system and implement pillar two and pillar three systems. These laws still need substantial work to finalize and ready them for passage.

◆ Policymakers might also consider a different approach to pension reform. Rather than drafting detailed laws now and attempting to quickly create a domestic fiduciary and asset management industry, policymakers should consider holding an

international tender offer that asks (by the terms of the tender) only the world's best qualified custodial and money management firms to come to Ukraine and set-up operations (pursuant to the laws and operational procedures under which these firms are already operating). This would offer immediate "best practices" for Ukraine, and begin the knowledge transfer process.

7. Corporate Governance: Restructuring and Attracting Capital

◆ Meaningful privatization only occurs when newly owned enterprises are restructured to run more efficiently and gain the benefits of private ownership. Marketing and sales skills must be sharpened, new production technologies and management methods introduced, quality control increased, new markets found, effective incentive structures introduced, improved information management systems put in place, staffing levels reduced to appropriate levels, product lines closed and new ones initiated, and so on. Corporate governance should facilitate post-privatization corporate restructuring. Unfortunately, this has not yet happened on a wide scale in Ukraine, and consequently privatization has not improved productivity, profitability or living standards.

◆ There are many reasons why restructuring has been limited. Private ownership of shares is widely dispersed and unorganized. Accumulation and concentration of capital with strategic investors (efficient owners) capable of instituting real change has been slow. Even when outsiders are able to acquire a significant holding, and have the expertise and resources to bring about change at a company, that change is often thwarted by entrenched management and a legal regime that does not empower minority shareholders. Managers are often profiting from the current structure and have little motivation to institute broad changes themselves. Further, the proper incentive system is not functioning: companies practicing good corporate governance are not rewarded with increased investment (because of the weak overall market), and companies practicing bad corporate governance are not exposed or subjected to penalties. Finally, the possibility of using cash substitutes (barter and negotiable instruments (veksels)) encourages companies to get by with subsistence level operations and avoid bankruptcy.

◆ In addition to playing a role in fostering restructuring, good corporate governance is also crucial for enterprises to attract capital. Enterprises have two potential sources of capital – creditors and strategic investors – and good corporate governance practices are important for both. If the law and the company's internal documents allow management or a controlling shareholder to direct the company's affairs for their private benefit, then no loan or equity investment will be forthcoming.

◆ Current corporate governance practices of Ukrainian enterprises are not acceptable by international standards. The current law governing joint stock companies, the law "On Business Associations," allows companies to harm shareholders and creditors, while technically complying with the law. Four practices are of particular concern to investors: i) share dilution, when companies issue shares to managers or favored investors at below market value; ii) asset stripping, when a company transfers assets, at below market value, to an entity affiliated with management or affiliated with a large shareholder (or the State); iii) profit skimming, when managers or large shareholders divert profits to their private benefit; and iv) transactions involving "off balance sheet" entities (i.e., subsidiaries), when businesses are structured so that profits accrue to subsidiaries rather than to the parent company.

◆ A draft law "On Joint Stock Companies" has been developed that will address these and other problems. Policymakers should finalize and pass the draft

law quickly (particularly if strategic privatization is accelerated, as planned, because this will only increase the opportunities for abuse).

◆ Policymakers should also work actively to promote reform at joint stock companies now, even before passage of a new law. Many protections for creditors and shareholders, as well as other useful provisions, can be added to a company's internal documents. Several enterprises in Ukraine have already begun to make these changes in order to attract investment. A "model" charter and by-laws with many of these protections is available to companies. In addition, intensive and sustained training of supervisory board members is needed so that they can fulfill their assigned functions overseeing managers and defending the interests of the company and its shareholders. Finally, equally intensive training of managers themselves is needed so that they learn new skills, including all aspects of modern business plans and information systems.

8. Internationally Accepted Accounting and Auditing Practices

◆ Accounting reform is at the center of financial markets development. If financial markets are to efficiently allocate capital to those enterprises best able to use it to expand and create jobs, investors and creditors must have full and reliable information about enterprises seeking capital. The higher the quality of information, the more efficient the capital allocation decisions. Equally important, reliable accounting information and full financial disclosure are necessary for good corporate governance practices, access to international capital, and a fair and effective tax system.

◆ Under the Soviet-style accounting system, company balance sheets and income statements often overstate actual economic status and performance. Further, no information on cash flow is provided. Consequently, Ukraine has recently embarked on an ambitious accounting reform project to introduce internationally accepted practices, including National Accounting Standards (NAS) that are consistent with International Accounting Standards (IAS). Ukrainian companies will be required to completely change the way they prepare and maintain financial information. Completing the development of NAS, along with a new chart of accounts and instructions, and implementing accounting reform is a major undertaking. A focused, sustained and coordinated effort is needed to train accountants throughout Ukraine in the basics of NAS.

◆ The old system of Communist Party control over enterprise directors is gone, and nothing has been put in its place. As a result, many enterprise directors feel free to act in their own self interest, and do so without constraint. In a market economy, a system of independent (external) audits is one of the primary "control" mechanisms over managers. Thus, accounting reform in Ukraine must be accompanied by reform and development of auditing practices.

◆ A system of good *internal* auditing is also important for companies to operate effectively in a market economy. Internal audits improve corporate governance by ensuring that the management and supervisory boards are aware of problems in the company. Internal audits also provide an incentive (fear) for company officials to stay honest and follow company procedures. Finally, internal audits assure top managers that they have reliable information about the enterprise with which to improve the company's operations. Thus, training and information should be provided to help companies implement effective internal audit procedures.

9. Taxes, Duties, Fees and Fines

◆ Tax policy will have a negative effect on financial markets development if taxes are excessive, or tax policy is inconsistent, or unfair. All three are true in Ukraine. Although the Value-Added Tax rate and the Enterprise Profit Tax rate are generally in line with rates in neighboring Central European countries, the overall burden on businesses appears to be higher than in these neighboring countries, primarily because of the myriad other taxes, duties, fees, contributions, inspections, fines and government interventions to which businesses are subject. The average small and medium-size business reported that they completed 46 tax forms in 1998, with some reporting figures as high as 300 tax forms.

◆ The tax burden falls disproportionately on a small number of profitable, reporting enterprises, because a large number of enterprises are losing money and thus do not owe any taxes, other enterprises simply run up arrears by not paying taxes, and more than half of all economic activity is in the shadows. Broadening the tax base would allow reduction of the overall level of taxes (duties, fees, fines and other contributions) without reducing the amount of funds flowing to the state. In addition, tax privileges exacerbate the problem. Tax privileges result in efficient, profitable enterprises being taxed to subsidize value-destroying enterprises that are wasting the country's resources.

◆ There have been some significant positive steps taken recently. Most importantly, starting with the budget year beginning January 1, 2000, off-budget funding will be eliminated for almost all agencies, including the State Tax Administration (STA). "Off-budget funding" refers to funding received directly from fees, duties, or taxes the agencies themselves collect, rather than from the State budget. Another important step, related specifically to the financial markets, was passage of the Law of Ukraine "On Introduction of Amendments to Particular Laws of Ukraine in order to Stimulate Investment Activity," dated July 15, 1999, which introduced amendments to the value added tax and enterprise profit tax laws and resolved a number of problems connected with taxation of financial markets transactions and services.

◆ Still, major tax reform is needed. A new tax code must be passed, followed by a major initiative involving taxpayer education, simplified forms and instructions, and training of tax officials on the new law and procedures. The STA needs to take further steps to modernize its revenue collection system to lower the cost of compliance, reduce corruption, and make collections more efficient.

◆ Ukraine has embarked on a major accounting reform initiative. To ensure the success of this reform effort, we urge policymakers to allow use of NAS for tax purposes to the extent possible, thereby reducing the complexity of the adjustment from a company's financial statements to its tax return.

10. Contract Enforcement

◆ Financial markets development requires that the participants have a confident expectation that transactions will be completed. This requires reliable mechanisms for contract enforcement. Failure to honor contracts is one of the most widespread complaints about the business climate in Ukraine. Mafia-type enforcement mechanisms flourish, and businesses tend to enter into transactions only within a small circle of those they know and trust, limiting overall commercial activity. It appears that the problem is neither lack of legislation nor lack of familiarity with international standards, but rather that the law is so routinely ignored, and that practical execution and enforcement of the law is so difficult. One problem is the lack of a credible threat of bankruptcy, usually one of the most effective ways of enforcing contracts. Managers and directors must feel that, if they fail to honor contracts for

delivery and payment, the other party could force the company into bankruptcy and they could lose their job and/or their ownership interest in the company.

◆ The discussion of contract enforcement can be framed in terms of pre-contract "due diligence," court decisions, and enforcement of judgments. Parties entering into contracts in Ukraine often find that problems arise at the earliest stages because of the difficulty of confirming information about the other party to the contract (i.e., performing "due diligence"). In part, this is due to an absence of public registries. There is no registry of title to real property; no reliable registry of legal entities and other subjects of entrepreneurial activity; and no registry of bankruptcy cases. In addition, it is difficult to get a true picture of the other party to a contract because companies commonly keep two sets of books in order to hide the true value of transactions and salaries, and engage in barter transactions that are hard to value accurately.

◆ If a contract dispute ends up in court in Ukraine, it is extremely difficult to predict how the matter will be decided. Consequently, there is no way to know how written laws will be interpreted in fact. This lack of predictability is a critical problem facing contracting parties in Ukraine. Further, execution of judgments is also a problem. Arbitration courts must transfer judgments to the Court Executor of the general courts for execution. Losing litigants are frequently able to hide their assets, either before or after judgment. Although the Court Executor can seize property and can order Government officials to comply with judgments, it is hampered by low pay, no public respect of court decisions, no enforcement mechanism (e.g., it cannot subpoena someone to ask where assets are hidden), and a cash economy.

◆ Business people need to be educated on the use of "self-help" mechanisms that do not require judicial enforcement, such as clauses in contracts that provide for "self-help" seizure of property upon breach of contract; use of letters of credit and trustees or escrow agents to guarantee performance; and resolution of disputes by pre-selected third parties (formal or informal arbitration).

11. Increasing Investment by Restructuring Production Costs: Commodity Exchanges, Barter, Veksels, Corruption, and the Shadow Economy

◆ Reforms to bring the costs of production in Ukraine down to market levels are an effective and sustainable strategy to make the country more attractive for investors, superior to "quick fix" policies such as tax privileges, subsidies to investors, loan guarantees, and so on. Such "quick fix" benefits are a drain on the budget and can actually make the investment climate worse because they are not sustainable and can be taken away as easily as they are given.

◆ Domestic production inputs in Ukraine are artificially overpriced. In some cases, this is the result of Government policies – e.g., enterprises commonly pay more than the market cost for energy as a result of Government efforts to cross-subsidize households. In other cases, it is the result of the non-payments crisis – those that pay subsidize those that do not pay – or the widespread use of "money surrogates" such as barter and negotiable instruments ("veksels") that increase transactions costs. In still other cases, it is the result of market imperfections: the market for production inputs in Ukraine is inefficient and non-transparent.

◆ Worse yet, the players have developed various schemes to take advantage of the inefficiency and non-transparency of the production inputs market. For example, trader intermediaries often sell energy and raw materials to enterprises at artificially high prices, sometimes sharing some of their "super-profits" with

enterprise managers. Mark-ups can be between 100 - 300 percent. Enterprises cannot switch to cheaper, better-quality raw materials from the West due to a lack of cash. Enterprises with such high costs, selling into a market in which cheap imported goods are also available, are forced to operate at a loss. There are many other often complex schemes involving intermediaries, the aim of which is usually both tax evasion and profit skimming. As a result of these schemes, profits move from enterprise owners (the State or shareholders) into private hands.

◆ Reducing the cost of domestically-produced production inputs will require a sustained, multi-pronged effort. One recommended approach is to encourage the development of market infrastructure. Efficient commodity exchanges for metals, energy resources, and agricultural products would provide for competitive trading of these resources, leading to lower prices and more transparency. The GOU has recently taken steps to revive commodity exchanges by channeling all purchases for, and sales from, State reserves through certain approved exchanges. These steps are to be applauded, but monitored closely to ensure that State bodies do not use this mechanism to control prices and grain movements. Trading should be attracted onto exchanges through improvements in infrastructure, rather than forced through heavy-handed requirements such as that all grain contracts be registered at exchanges.

◆ Late payment, non-payment, and payment using cash substitutes are a serious problem in all of the production input sectors, resulting in increased prices for those who do pay. The culture of non-payment for electricity is particularly pernicious. Incentives are needed to improve collection rates.

◆ Since independence, Ukraine has witnessed a startling increase in pseudo-market forms of settlement such as barter, mutual settlement of outstanding debts, and veksels. The main cause of this is the shortage of money supply in the economy caused by a combination of tight monetary policy and lax fiscal policy. Enterprises have no cash to pay their suppliers. Other causes include reluctance to use the banking system by taxpayers engaged in tax evasion; the ease with which managers can avoid taxes and commit fraud using these non-transparent payment mechanisms; and the general "shadowization" of the economy.

◆ Barter contracts are very costly, particularly for firms that conclude contracts with unfamiliar partners for the first time and thus have limited information about a trading partner. To reduce these costs, enterprises sometimes use veksels, but veksels are still considerably more costly than cash settlements. In addition to increasing costs, the widespread use of money surrogates in Ukraine causes other problems, such as complicating monetary policy by weakening the NBU's direct control over liquidity in the economy, and allowing enterprise managers to skim profits and enterprises to avoid paying taxes. Further, employees receiving wages in goods must expend considerable resources to convert the goods into cash or products needed for consumption. And the use of veksels and barter significantly complicates determination of the real financial position of enterprises and reduces the accuracy of financial disclosure.

◆ Ukraine should take gradual steps to restrict the use of money surrogates. Ironically, much of the use of money surrogates is Government sponsored, often as a way of effectively expanding the money supply. This is perhaps most egregious in the agricultural sector, where the Government barters inputs for crops. As a result, farmers "buy" inputs high and "sell" outputs low, resulting in a lack of profits and new investment.

◆ Successfully reducing the use of money surrogates will require reducing the shadow economy, as money surrogates are what the shadow economy uses to avoid detection. And reducing the shadow economy is inevitably tied to efforts to reduce corruption, which in turn is one of the keys to developing continued and sustainable economic growth in the economy.

Conclusion

◆ Enterprises in Ukraine desperately need the capital and know-how provided by healthy financial markets. The State needs the increased revenues from privatization that will follow from financial markets reform. Ukraine must begin attracting serious strategic investors to invest in the country, and begin attracting significant amounts of money into the banking system. These fresh sources of capital will lead to job creation and an expansion of the economy.

◆ Ukraine can successfully develop its financial markets. The initiatives outlined in this Paper, as refined by Ukrainian officials, can establish an enabling regulatory climate, efficient market architecture, and empowered private sector actors. These improvements, in turn, will facilitate the emergence of developed financial markets in Ukraine over the next five years.

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